

ACCOUNTING FOR MOTION PICTURES:  
AN EXAMINATION OF THE QUALITY OF TWO  
ACCOUNTING STANDARDS

An Undergraduate Distinction Project

Presented in Partial Fulfillment of the Requirements for

Graduation with Distinction in the

College of Business at The Ohio State University

By

Deborah Lynn Wiece

\* \* \* \* \*

The Ohio State University  
2000

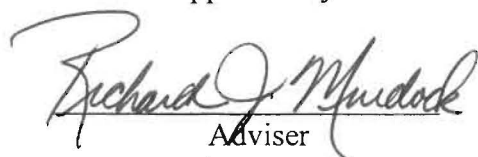
Distinction Examination Committee:

Dr. Richard Murdock, Adviser

Dr. Daniel Jensen

Dr. Raymond Krasniewski

Approved by



Adviser

Department of Accounting and MIS

## **ABSTRACT**

FAS 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, was issued in 1981 and set the requirements for external financial reporting in the motion picture industry. However, due primarily to changes in the industry since then, there have been many criticisms regarding the statement. In an attempt to address these criticisms, a proposed Statement of Position (PSOP) was written. This PSOP addresses some of the more controversial accounting methods allowed under FAS 53, and it requires more conservative income recognition policies.

The goal of this distinction project was to determine which of these two accounting standards—FAS 53 or the PSOP—is of higher quality, with my hypothesis being that the PSOP was a higher-quality standard. To determine the quality of a standard, one can look at the characteristics, primarily the relevance and reliability, of the information it provides. In order to assess the quality of the information, I asked users of financial statements for their opinions through the use of a survey. 150 surveys were sent out to entertainment industry professionals, public accountants, and university accounting professors, and a response rate of 11.33% was achieved. Despite the low response rate, respondents indicated a preference for the PSOP in most areas. Therefore, although the PSOP does not address all of the criticisms of FAS 53, it does significantly improve accounting for motion pictures, and thus it is the standard of higher quality.

## **ACKNOWLEDGMENTS**

I would like to thank Dr. Richard J Murdock for his help with my distinction project, as this would not have been completed without his guidance. My acknowledgements also go out to Rama Ramamurthy who greatly helped me with the written portion of the project. I would also like to thank Dr. Daniel Jensen and Dr. Raymond Krasniewski for serving on my distinction examination committee, Rob Leighty and Yanhong Yang for their help with the statistical analysis, and Mike Psomas for his assistance in putting together a mailing list. Finally, I wish to thank David Long, Julie McNeil, and Kristen Stiles for their help, patience, and support.

## VITA

### Work Experience

*Deloitte & Touche, LLP*

Audit Intern

Los Angeles, CA

January 2000 – March 2000

- Performed client auditing and became competent and efficient in executing audit procedures with thorough understanding of the components entailed.
- Developed increased technical knowledge while serving clients in the entertainment industry and the internet sales industry

*The Procter & Gamble Company*

Product Supply Finance Intern - Oral Care

Mason, OH

June 1999 – September 1999

- Conducted a financial analysis and prepared recommendation for sourcing of Crest Complete.
- Performed comprehensive competitive analysis project on global toothpaste brands.
- Developed detailed cost-savings proposal for global oral care, with main focus on manufacturing costs and purchasing improvements.

### Education

*The Ohio State University*

BSBA with honors and distinction in Accounting

Summa cum laude

Women's Studies Minor

Columbus, OH

June 2000

cumulative GPA: 3.97

Tax Challenge National Qualifies

Beta Alpha Psi National Manuscript Contest, 2<sup>nd</sup> place

Ernst & Young Excellence in Education Award

Robert E. Georges Pace Setters Senior Scholarship

Beta Gamma Sigma Honor Society

Phi Kappa Phi National Honor Society

Beta Alpha Psi Accounting Fraternity



## TABLE OF CONTENTS

	<u>Page</u>
Abstract.....	ii
Acknowledgments.....	iii
Vita.....	iv
 Chapters:	
1. Introduction.....	1
1.1 Introduction.....	1
1.2 Pre-FAS 53.....	2
1.3 AICPA Industry Guide.....	2
1.3.1 Revenue Recognition.....	2
1.3.2 Amortization of Production Costs.....	4
1.3.3 Ultimate Gross Revenue Projections.....	5
1.3.4 Summary of Guide.....	5
1.4 FAS 53.....	6
1.4.1 Production Costs.....	6
1.4.2 Exploitation Costs.....	6
1.4.3 Participations and Residuals.....	7
1.4.4 Abandoned Projects.....	8
1.4.5 Other Accounting Methods in FAS 53.....	8
1.5 Criticisms of FAS 53.....	9
1.5.1 Amortization of Costs.....	9
1.5.2 Changes in the Industry.....	10
1.5.3 Cannon Films.....	10
1.5.4 Orion Pictures.....	11
1.6 Proposed Statement of Position (PSOP).....	12
1.6.1 Amortization of Production Costs.....	12
1.6.2 Exploitation Costs.....	13
1.6.3 Overhead Pool.....	13
1.6.4 Revenue Recognition.....	14
1.7 Motivation and Interest.....	14

2.	Qualities of Good Accounting Standards.....	16
2.1	Introduction.....	16
2.2	Focus of Project.....	16
2.3	Relevance.....	17
2.4	Reliability.....	18
2.5	Conservatism.....	18
2.6	Comparability and Conservatism.....	19
2.7	Relevance and Reliability of FAS 53 and the PSOP.....	20
2.7.1	Timeliness.....	20
2.7.2	Predictive Value.....	22
2.7.3	Feedback Value.....	22
2.7.4	Verifiability.....	23
2.7.5	Representational Faithfulness.....	23
2.7.6	Comparability.....	24
2.7.7	Conservatism.....	26
2.8	Hypotheses.....	27
2.9	Qualities of Good Accounting Standards.....	28
2.9.1	FAS 95.....	28
2.9.2	FAS 5.....	29
2.9.3	FAS 87.....	29
2.10	Qualities of Bad Accounting Standards.....	30
3.	Research Methodology.....	31
3.1	Introduction.....	31
3.2	Survey Respondents.....	31
3.2.1	Three Groups.....	31
3.2.2	Risk in Selections.....	32
3.3	Survey Design.....	33
3.3.1	Format of Survey.....	33
3.3.2	Focus of Survey.....	34
3.3.3	Question-Order Effect.....	36
3.3.4	Successful Efforts.....	37
3.3.5	Advertising Costs.....	38
3.3.6	Amortization Period.....	39
3.3.7	Revenue Recognition.....	40
3.3.8	Ultimate Gross Revenue Projections.....	43
4.	Data Analysis and Results.....	45
4.1	Introduction.....	45
4.2	Response Rate.....	46
4.3	Nonresponse Bias.....	47

4.4	Cronbach's Alpha.....	47
	Table 4.1: Consistency Groups.....	48
	Table 4.2: Cronbach's Alphas.....	48
4.5	Wilcoxon Signed Rank.....	49
	Table 4.3: Wilcoxon Statistics and Estimated Medians.....	50
4.6	P-Value.....	51
	Table 4.4: P-values.....	51
4.7	Results.....	52
4.7.1	Exploitation Costs.....	52
4.7.2	Abandoned Projects.....	53
4.7.3	Revenue Recognition.....	55
4.7.4	Ultimate Gross Revenue Projections.....	56
4.7.5	Amortization Period.....	58
5.	Conclusion.....	60
5.1	Summary.....	60
5.1.1	Introduction.....	60
5.1.2	FAS 53 and the PSOP.....	61
5.1.3	Research Methodology.....	61
5.1.4	Statistical Results.....	63
5.2	Conclusions.....	64
5.2.1	Hypothesis H <sub>1</sub> : Exploitation Costs.....	64
5.2.2	Hypothesis H <sub>2</sub> : Abandoned Projects.....	65
5.2.3	Hypothesis H <sub>3</sub> : Revenue Recognition.....	66
5.2.4	Hypothesis H <sub>4</sub> : Ultimate Gross Revenue Projections.....	66
5.2.5	Hypothesis H <sub>5</sub> : Amortization Period.....	67
5.2.6	Hypothesis H <sub>6</sub> : FAS 53 v. the PSOP.....	68
5.3	Other Findings.....	70
5.3.1	Research.....	70
5.3.2	Response Rate.....	71
5.3.3	What to do Differently Next Time.....	71
5.4	Conclusion.....	73
	Bibliography.....	74

## **LIST OF APPENDICES**

Appendix A: Motion Picture Revenue Breakdown

Appendix B: Comparison of PSOP and FAS 53

Appendix C: Survey

Appendix D: Histograms: Questions Realigned so that High Score Suggests Preference  
for PSOP

## CHAPTER 1

### INTRODUCTION

#### Introduction

The Eddie Murphy film *Coming to America* was one of the highest grossing pictures in history, at \$350 million. Humorist Art Buchwald and producer Alain Bernheim, who wrote the script, were expecting their share of the net profits to be around \$930,000. Unfortunately, due to the use of rather “creative” contract accounting methods used by Paramount Pictures, the studio was able to declare *Coming to America* lost money<sup>1</sup>. Therefore, Buchwald and Bernheim received their share of the profits—nothing<sup>2</sup>.

The story of *Coming to America* is just one example of “creative” accounting methods used by motion picture studios. Although this example has more to do with contract accounting than external financial reporting, studios have also used “creative” methods when it comes to external reporting. Although studios are able to ignore GAAP for contract purposes, they are required to follow Statement of Financial Standards (FAS) No. 53, *Financial Reporting by Producers of Motion Picture Films* for external financial

---

<sup>1</sup> In fact, some people claim the accounting department is the most creative parts in Hollywood (O'Donnell and McDougal 213).

<sup>2</sup> They later sued Paramount and were awarded \$900,000.

reporting. This statement came out in 1981, and was based largely on *An AICPA Industry Guide: Accounting for Motion Picture Films*. In this project, my interest lies with GAAP, and therefore the purpose of this study will be to examine external financial reporting requirements in the motion picture industry.

## **Pre-FAS 53**

Prior to the issuance of FAS 53 or the AICPA Industry Guide, there were numerous methods of revenue recognition in use in the motion picture industry. Although companies basically used the same methods to recognize revenue from theatrical exhibition, as it is “fairly straightforward...ancillary market revenue recognition is potentially more complex” and, therefore, different methods of recognizing revenue from non-theatrical markets existed (Vogel 93). The first method in use was the contract method, which recognizes all revenue when the contract is executed. The second method recognizes revenue as installment payments become due, and is therefore known as the billing method. The delivery method recognizes revenue when the film is delivered, and the final method, the deferral method, recognizes revenue evenly over the whole license period.

## **AICPA Industry Guide**

### *Revenue Recognition*

The publication of the AICPA Industry Guide in 1973 “pragmatically resolved many (but far from all) controversial issues. Publication of that guide significantly

diminished the number of interpretations used in describing film industry transactions and thus made comparisons of one company's statements with those of another considerably easier and more meaningful than before" (Vogel 93). The Guide addressed the various methods regarding ancillary-market revenue that had been in use. The contract method was endorsed by the Guide, under the belief that "the signing of the contract is the significant event in the earning process" (Guide 5). The Guide referred to APB No. 10 for its decision on the billing method, and concluded that the installment is acceptable only if "collection of the sale price is not reasonably assured" (§12).

The Industry Guide prohibited both the delivery method and the deferral method of revenue recognition. The delivery method is not valid because it recognizes revenue when the product is delivered, and also because a motion picture is not considered to be a tangible product. The Guide also turned down the deferral method because it "overlooks the fact that licensee's use of film is limited to specific number of showings in a particular market, which can usually occur at any time the licensee chooses after the start of license period" (Guide 6).

The Guide also placed the industry on a uniform basis when it set the required conditions for recognition of revenue from the licensing of motion pictures to television, which was the primary ancillary market at that time. Harold Vogel lists the conditions that had to be met for revenue to be recognized:

The license fee (sales price) for each film is known; the cost of each film is known or reasonably assured; collectibility of the full license fee is reasonably assured; the film is accepted by the licensee in accordance with the conditions of the license agreement; the film is available; that is, the right is deliverable by the licensor and exercisable by the licensee (94).

### *Amortization of Production Costs*

Finally, the Guide unified the methods of amortizing production costs, which is based on the entertainment industry's unique definition of inventory. In the motion picture industry, production costs are capitalized and subsequently amortized as a film earns revenue. Merrill Lynch entertainment analyst Harold Vogel considers the classification of these costs as inventory to be "perhaps the greatest conceptual difference between the movie industry and other industries" (95). In most industries, inventory is classified on the balance sheet as a current asset. However, in the entertainment industry, a motion picture can be classified as either current or non-current, depending on the stage of the film. For example, the unamortized portion of a film in release would be considered a current asset, while a production still in-process would be considered a non-current asset.

Vogel describes the Guide's reasoning for the amortization of film costs:

Inventories are matched in a "cost-of-goods-sold" sense against a *forecasted* schedule of receipt of income. Of course, forecasts of films are mostly best guesses, although in the aggregate it is fairly certain that, on the average, perhaps 80% of all theater-exhibition revenues will be generated in the first nine months of release and almost all by the remainder of the end of the second year (96).

Therefore, costs are amortized based on the percentage of total revenue that the film has earned, which means that the total amount of revenue a film must be estimated. For example, if a motion picture which cost \$100,000 to produce, has ultimate gross revenue projections (estimates) of \$500,000, and revenues in the first year are \$400,000, then the amount of the film's cost which is amortized in that year is \$80,000 (which is 80% of the \$100,000).



### *Ultimate Gross Revenue Projections*

Two approaches to developing ultimate gross revenue projections were generally in use prior to the publication of the Industry Guide—the average table method and individual-film-forecast method. The first method uses tables that were developed based on the combined performance of previous motion pictures. A producer determines the estimated likely ultimate revenues of the film from the table based on the cost of the film as well as other inputs. This would then be used as the basis for amortization. The second method required the motion picture producer to develop its own estimates, relying solely on the film itself, not on industry averages. This method is the only method of developing revenue projections that is supported in the Industry Guide.

### *Summary of Guide*

The publication of the AICPA Industry Accounting Guide standardized many of the practices that were in use by the entertainment industry prior to its issuance. It accepted two methods of revenue recognition for non-theatrical markets—the contract method and the billing method (only if the conditions for the appropriate use of the installment method were met)—and disallowed the practice of the delivery method and the deferral method. The Guide set guidelines for the recognition of television revenue, and also required that ultimate revenue projections be developed based on the forecast from the individual film, not the industry average tables. Finally, the Guide unified the methods of amortizing production costs. It is for these reasons that the accounting methods in FAS 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, were largely extracted from the AICPA Industry Guide.

## **FAS 53**

### *Production Costs*

FAS 53 was issued in 1981 and also requires the amortization of capitalized production costs. Under this method, all of a motion picture's production costs, which include such costs as writing, acting, directing, and editing, as well as capitalized interest and production overhead allocations—are capitalized and are subsequently amortized against the revenues received from the film, over a period of up to twenty years. As was the practice under the Industry Guide, ultimate gross projections are developed for each film on an individual basis using the individual-film-forecast method. As FAS 53 does not specifically state what can be included in the projections, the revenue estimates can include non-theatrical revenues, as well as revenues from promotional items such as toys, clothing, and theme park rides, and they do not have to be discounted to present value.

### *Exploitation Costs*

Like production costs, FAS 53 also allows distribution costs to be capitalized. Distribution costs, commonly called exploitation costs in the entertainment industry, primarily refer to advertising and related costs, which is “far and away the most expensive distribution cost...and is spent before one dollar of film rental is earned” (Leedy 26). When clearly benefiting future periods, as in the case with national advertising, the costs are capitalized as inventory and amortized over a period in which the major portion of gross revenue is recorded. Exploitation costs that do not clearly

benefit future periods, as in the case of local advertising, are normally expensed as incurred.

There are four primary types of advertising costs in use in the motion picture industry. The first is known as trade advertising, and it refers to efforts made directly to people or organizations “in the trade” (Leedy 26). For example, an advertisement in an industry publication might be placed as soon as the story rights are purchased, even though filming may be as far away as a year. Network television advertising and theatrical advertising are the two types of advertising with which most people are familiar. In theatrical advertisements, trailers, sneak previews, and posters may be shown as much as a year prior to release date, while television commercials are usually aired just prior to release date. The fourth type of advertising, four-wall advertising, is very common outside of the U.S. The motion picture distributor actually “rents” the theater for a period of time to show the movie, and receives the excess of the box office receipts over the “rent” (Leedy 32).

### *Participations and Residuals*

The cost of participations and residuals are what often receive the most attention in Hollywood, as these are the amounts that are paid to actors, writers, and other creative talent according to their contracts. Using the example of *Coming to America* as mentioned in the introduction to this paper, the amount that Paramount would have owed to Art Buchwald and Alain Bernheim under their contracts is known as the “participations and residuals<sup>3</sup>.” FAS 53 does not require these amounts to be recorded as

---

<sup>3</sup> Participations refer to amounts payable based on contractual formulas, while residuals refer to contingent amounts due under collective bargaining agreements.

a liability until they actually become due. For example, if an actor's contract states that he is to receive a certain percentage of the net profits, no liability will be recorded until net profits are actually earned by the company. As was the case with Buchwald and Bernheim, these net profits may never materialize and therefore no liability truly exists.

#### *Abandoned Projects*

As described earlier, production costs are amortized based on the percentage of projected ultimate gross revenues earned in a period. Certain other costs that are not directly related to the production of the specific film may also be amortized against its revenues, however. Under FAS 53, motion picture production companies make use of an "overhead pool" which includes the costs of abandoned projects and scripts, as well as the costs from films that failed. This overhead pool is then amortized over films that do make money, based on the rationalization that the costs of these unsuccessful or abandoned projects may have helped lead to the success of other films.

#### *Other Accounting Methods in FAS 53*

Two other methods of accounting for motion pictures under FAS 53 are described below. The first deals with the fact that capitalized production costs are accounted for as inventory, not as long-term assets. Because of this classification, when the unamortized production costs exceeds the remaining ultimate revenues, the amount must be written down to the remaining revenue—the net realizable value, or the net amount expected to be received. The second method involves the recognition of syndication revenues. FAS 53 requires recognition at the moment of delivery of the episodes. That means that when

a producer/distributor licenses a product, all of the revenue is recognized upon delivery of the episodes, even if the license period is a number of years.

### **Criticisms of FAS 53**

Harold Vogel offers the opinion that FAS 53 “has contributed to a much-improved basis for comparison of film and television company financial data versus the relatively amorphous conditions that had prevailed prior to its issuance, yet the statement has nevertheless drawn criticism” (Vogel 100). The primary criticisms of FAS 53 relate to the process for developing the ultimate gross revenue projections and companies’ variations in interpretations of the statement. Additionally, changes in the movie industry and in the economy itself have brought criticism that FAS 53 no longer applies.

#### *Amortization of Costs*

In an industry such as manufactured consumer goods, the amortization of costs such as overhead typically account for only a small portion of the total expenses. However, in the motion picture industry, these costs play a much more important role, and therefore, much of the criticism of FAS 53 relates to its treatment of these costs. In the entertainment industry,

“The rate of amortization depends on management’s projections of often uncertain revenue streams that are expected to be received sometime in the possibly distant future...Thus, under 53, there is ample room for substantial variation in earnings reporting practices to appear, and it is essential for the analyst comparing one company to another to understand such differences” (Vogel 100).

### *Changes in the Industry*

Problems in the application of FAS 53 have also been attributed to changes in the industry and in the economy. Traditionally, and at the time of the issuance of FAS 53, the majority of revenues from a film were realized through theatrical exhibition. That “gradually began to change as television’s appetite for movies increased and as receipts grew with audience size” (Vogel 98). Since the mid-1980s, revenues from the licensing of films (for such use as network television, cable, and home video) surpassed the amount of revenues from theaters. In fact, revenues from the sales of home videos alone often exceed theatrical revenues (Leedy, Daniels, and Sills 61). (See Appendix A for the breakdown of motion picture revenues.) Therefore, the problem results when management is in the process of developing gross revenue projections for a film. Revenues from ancillary markets are important revenue sources, and therefore can be included in the projections. Promotional items, such as toys and CD-ROMs can therefore be included, which makes the estimation process even more difficult. As revenues from these items are uncertain, and FAS 53 is not clear on what should be included in the projections, companies have adopted varying methods of projecting gross revenues.

### *Cannon Films*

Cannon Films is the example most often used by critics of FAS 53. In the late 1980s, Cannon Films was one of the largest independent movie studios, producing such films as *American Ninja*. Cannon was able to manipulate its income by estimating

revenues that were much higher than what the films ever earned<sup>4</sup>. As costs are amortized based on the percentage of revenues earned, Cannon was amortizing only a small fraction of the production costs than it would have with more conservative estimates; thus it over-reported income. In 1987, the SEC took action against Cannon and “sought a permanent injunction to restrict it from overestimating anticipated revenues” (Atlas 61). When Cannon was forced not to be so aggressive, or “creative,” with its accounting, its stock dropped from over \$40 per share to nearly \$3 per share, its “huge profits turned into crushing losses” and the company ceased to exist (Daniels, Leedy, and Sills 267).

### *Orion Pictures*

Orion Pictures, the company that produced such films as *The Silence of the Lambs* and *Dances with Wolves*, is the more recent example of a motion picture company that bent the rules of FAS 53 to help portray a financial position that was more favorable than what actually existed. Like Cannon, Orion also used aggressive accounting tactics to boost its earnings. Orion also introduced a new manipulation of FAS 53, when it delayed the write-down of films to net realizable value, “with the hope that a string of smash hits would rescue it from its growing debt load” (Grover 56). Orion is an example of how FAS 53 allows a company to report earnings, yet be insolvent at the same time. “It is thus often argued that the accounting picture rendered by application of FASB statement 53 may not accurately reflect the true earnings power, cash-flow potential, or asset-value of a company” (Vogel 100).

---

<sup>4</sup> Although this may be more of a case of unethical management than of a problem with the accounting standard, the over-estimation of revenues was made possible because FAS 53 did not clearly describe what should be included in gross revenue projections.

### **Proposed Statement of Position (PSOP)**

“Concurrent with these changes in the industry, significant variations in the application of FASB Statement No. 53 have arisen. In addition, business failures of certain entities in the industry have raised concerns about the application of FASB Statement No. 53” (PSOP ¶2). As a result of these concerns, the FASB and the AICPA have agreed that a new accounting standard should be issued. Therefore, AcSEC (Accounting Standards Executive Committee) has proposed a statement of opinion (PSOP), which introduces changes in the methods of accounting for motion pictures. If the PSOP is approved, FASB has agreed to rescind FAS 53. In essence, the PSOP was written to prevent the “extremely liberal financial interpretations like those applied by Cannon Films and Orion Pictures” (Berton and Harris 36). See Appendix B for the differences between FAS 53 and the PSOP.

#### *Amortization of Production Costs*

There are several changes to motion picture accounting in the PSOP, which apply tighter controls to cost amortization and revenue recognition. The first change relates to the ultimate gross revenue projections. As with FAS 53, the PSOP requires the use of the individual-film-forecast method, but production costs, which are amortized against the revenue estimates from a film, would be amortized over a period not exceeding ten years, as opposed to the twenty years allowed under FAS 53. Another proposal that relates to the process of projecting ultimate gross revenues is what can no longer be included in the projections: “Ultimate gross revenues should not include revenues from the entity’s



manufacture and sale of peripheral items, such as lunch boxes, toys, tee shirts, and so forth” (PSOP ¶29).

### *Exploitation Costs*

Another major change in the PSOP deals with exploitation or distribution costs, which as discussed earlier, primarily consist of advertising costs. Under the rules promulgated by the PSOP, advertising costs will be expensed as incurred. This is consistent with the treatment given to advertising costs for most industries in SOP 93-7, *Reporting on Advertising Costs*, because the probable future benefits of the advertising are uncertain and are not “measurable with a degree of reliability required to recognize an asset” (PSOP ¶74). In the PSOP, AcSEC notes that although “in the motion picture industry the pattern of incurring exploitation costs differs significantly from the pattern in other industries” (¶69), it wants “to limit diversity in practice” (¶74).

### *Overhead Pool*

A third major change to motion picture accounting under the PSOP concerns the valuation of film costs, specifically the treatment of the overhead pool. As mentioned earlier, under FAS 53 the cost of abandoned projects and losses from unsuccessful films are added to the overhead pool. This pool is then amortized over the earnings of successful films, thus lowering the income for any one particular film and delaying the recognition of certain losses (although over time, the overall income of the production company is essentially unchanged). The PSOP would no longer allow the costs of these abandoned projects and scripts to be included in the overhead pool; instead they would be written off directly to the income statement. The PSOP assumes that if a property “has

not been set for production within three years from the time of the first capitalized transaction...any loss should be recognized by a direct charge to income” (§40).

### *Revenue Recognition*

The PSOP also proposes a change in the point at which revenue from a licensed film can be recognized. Under FAS 53, the entire revenue amount is recognized upon delivery. The PSOP proposes that revenue be recorded ratably over the entire license period, instead of on the first available pay date. The PSOP also does not consider delivery to be enough to allow for the recognition of revenue. Instead, the PSOP allows revenue recognition only when modifications to the film, as required by the contract between the licensor and licensee, are complete: “Arrangements that may require an entity to make significant changes to a film after its delivery preclude an entity from recognizing revenue on that film until those changes are made. Examples of changes that are significant include dubbing in a different language, adding subtitles, or adding film content (PSOP ¶12).

### **Motivation and Interest**

Although I only had a brief exposure to the motion picture industry in my accounting classes, I chose to study this industry for a number of reasons. My primary motivation is simply that I have always had an intense interest in entertainment. For the last few years, I have fully intended on moving to Los Angeles after graduation and work in the industry. I even spent a quarter as an audit intern for a Big Five accounting firm, where I was able to work on entertainment clients. Although my career plans for

immediately after graduation have since changed, I still hope to some day return to the entertainment industry. The second reason I chose this topic is because it was an area that I knew little about before I began my research. I therefore felt I could use my theoretical accounting knowledge on issues such as revenue recognition and expense matching, and apply it to a unique topic in a specific industry.

## **CHAPTER 2**

### **QUALITIES OF GOOD ACCOUNTING STANDARDS**

#### **Introduction**

Users of financial statements, including both investors and creditors, rely on the information provided in those statements in making their decisions. Users' decisions may, in fact, be solely or at least heavily based on that information. For this reason, according to David Solomons, a company's stock price is more a function of accounting policy than of the company's actual operations (3). Accounting standards are important because they determine what information is to be given to users and how that information should be presented. The standards need to ensure responsiveness to needs and viewpoints of the entire economy.<sup>5</sup> The most effective standard—and therefore the highest quality standard—will be the one that provides the most useful information to users.

#### **Focus of Project**

In this project, I will focus on the two standards dealing with accounting for

---

<sup>5</sup> Perhaps that explains the lengthy process of creating a new FAS—which is the top level in GAAP hierarchy, along with APB Opinions and AICPA Research Bulletins (SAS No. 69 ¶15).

motion pictures—FAS 53 and the PSOP—and I will attempt to determine which is of higher quality. As stated earlier, this can be accomplished by determining which provides better accounting information to users. Thus, I must first establish exactly what constitutes “better accounting information.” Statement of Financial Accounting Concepts (SFAC) No. 1 states that the primary objective of financial reporting (and hence the goal of an accounting standard) is that it is useful to decision-makers (§33). APBS No. 4 states: “The basic purpose of financial accounting and financial statements is to provide financial information about individual business enterprises that is useful in making economic decisions (§13).” SFAC No. 2 describes the characteristics that make accounting information useful to decision-makers: relevance and reliability. Therefore, a quality accounting standard will provide information that is both relevant and reliable.

## **Relevance**

Relevance is defined as the capacity of information to make “a difference in a decision by helping users to form predictions about the outcome of past, present and future events or to confirm or correct prior expectations” (SFAC No. 2 §47). Based on this definition, it becomes apparent that information is relevant if it is timely and possesses either predictive value or feedback value. Timeliness means that the information is available to the decision-maker when he or she needs it—before the information loses its ability to influence the decision. Predictive value means that the information has the ability to help a user forecast the consequences of past or present events, while feedback value means that the information “can make a difference to

decisions by improving decision makers' capabilities by confirming or correcting their earlier expectations" (SFAC No. 2 ¶51).

## **Reliability**

Just as relevance could be examined through three different qualities of information, reliability can also be examined through three characteristics—verifiability, representational faithfulness, and neutrality. Information is verifiable if a large group of independent users will arrive at the same conclusion based on the information.

Verifiability assures the absence of error or bias. SFAC No. 2 defines representational faithfulness, also known as validity, as “correspondence or agreement between a measure or description and the phenomenon that it purports to represent” (¶63). In other words, the chosen inputs will indeed result in the desired output. Finally, neutrality means that the information is free from bias—there is no predetermined end. The use of LIFO as an inventory-costing method is an example of an accounting policy that does not possess neutrality when it used solely for the specific purpose of reducing income taxes (Solomons 101).

## **Conservatism**

Besides relevance and reliability, there are several additional characteristics of information that may affect the quality of an accounting standard, the first of which is conservatism. Although SFAC No. 2 emphasizes that it is to be “applied with care” (¶92), “many accountants rate it [conservatism] above all others” (Solomons 99).

According to SFAC No. 2, conservatism “does not connote deliberate, consistent understatement of net assets and profits” (§93). Instead, the use of conservatism is described as follows: “If two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the more pessimistic amount rather than the more likely one” (SFAC No.2 §95). It is an attempt to ensure that uncertainties and risks inherent to a company have been considered in the creation of the numbers on the financial statements. However, conservatism may actually make information less reliable, as it may force the recognition of certain gains or losses in the improper time period (Solomons 100).

### **Comparability and Consistency**

Comparability and consistency are both considered to be secondary qualities of accounting information. Comparability means that comparisons of information between two or more businesses can be accurately made, while consistency relates to comparisons within a company over a period of time. Finally, there are two constraints listed in the hierarchy of accounting qualities: the cost-benefit constraint and the materiality constraint. The cost-benefit constraint simply means that the benefits derived from information outweigh the costs of preparing and analyzing the information. Materiality is known as a “threshold for recognition,” meaning that information should be included only if its exclusion would change or influence a user’s decision.

## **Relevance and Reliability of FAS 53 and the PSOP**

The quality of an accounting standard can be judged by the quality of information it provides, and the best information is information that is useful to decision-makers, or in other words, information that is both relevant and reliable. Since the purpose of this project is to ascertain which of the motion picture accounting standards provides better information, I will directly compare the two standards and assess their relevance and reliability. I will also consider the other qualities inherent in the standards, namely comparability, consistency, and conservatism, as well as the cost-benefit and materiality constraints<sup>6</sup>.

### ***Timeliness***

The first ingredient of relevance that I will examine is timeliness. Under FAS 53, advertising costs are not expensed as incurred. Instead, it is assumed that advertising costs will benefit future periods, and they are therefore capitalized as production costs. A company can amortize these costs over all markets. This means that the costs of advertising a movie for theatrical release in Columbus, Ohio, though most likely having no effect on videotape sales in Paris, France, will still be amortized over revenues from the European market (Vogel 99). The PSOP changes this practice by requiring that advertising costs be expensed as incurred, as the probably future economic benefits of advertising are largely uncertain. The PSOP also addresses the issue of amortizing these costs over different markets: "Exploitation [marketing, advertising, etc] costs incurred in

---

<sup>6</sup> As PSOP is not yet in effect, we cannot look at actual financial information prepared following its requirements. Therefore, it is necessary to make assumptions about the presentation of the information and how that information would be used.



connection with the release of a film in markets other than the theatrical market should be expensed as incurred” (11). Timely information helps a user make a decision at the present time. If advertising costs are amortized over a period as long as, for example, fifteen years, then at the beginning of a film’s release, a user does not have the information needed to make a good decision. That information will come within the next fifteen years, which may be too late. However, the more likely case under FAS 53 is that advertising costs are fully amortized over a period of about three months. Therefore, based on the extreme example, it appears that the PSOP provides more timely information than FAS 53, but in practice, both standards would provide the information in about the same time period.

On the other hand, some entertainment experts assume that videotape sales in Paris will not be successful if theatrical revenues in the US are poor, as “advertising costs incurred during theatrical release create values in the ancillary markets” (Vogel 99). And of course, successful theatrical revenues depend on a large amount of advertising prior to and at the beginning of a film’s release. Therefore, exploitation costs should be capitalized and amortized over the life of the film. If this is the case, then one may assert that FAS 53 may actually have more predictive value. As the cost of advertising and publicity is “far and away the most expensive distribution cost,” and most of it occurs before the theatrical release of a film, then a film will show a huge loss at the beginning of its release under the PSOP’s guidelines (Leedy 26). A user may then not be able to make an accurate prediction on the potential financial success of a film, as most or even all films will begin with a huge net loss.

### *Predictive Value*

The predictive value of the information provided by the two statements can also be examined by looking at the costs of abandoned scripts and projects. The PSOP considers an abandoned project one that has “not been set for production within three years from the time of the first capitalized transaction” (§14), though entertainment industry expert Harold Vogel notes that often times, a film project will “be lost in creative limbo for relatively long periods” (99).<sup>7</sup> Under FAS 53, the cost of these abandoned projects are allocated to the overhead pool and subsequently amortized over several years. The PSOP, however, requires that the cost of any abandoned project be charged directly to income. A direct charge most likely is a signifier of the abandonment of a project than an allocation to an overhead pool; thus a user can more clearly predict the outcome of a past event. Based on the above, it appears that both FAS 53 and the PSOP result in information that provides users with predictive value.

### *Feedback Value*

Abandoned scripts and projects can also be used as an example of feedback value. As stated earlier, a project is considered to have begun with the first capitalized transaction. A user of financial information is likely to make a prediction about this future project---perhaps she is expecting it to be a huge blockbuster hit. Then, a year later as required by the PSOP, the project is written off to income as a loss. She, therefore, can correct her prior expectation, meaning the information required by the PSOP had feedback value. On the other hand, under FAS 53, the amount is allocated to

---

<sup>7</sup> Consider for example, the case of *Coming to America*, as used in the introduction to this paper. Art Buchwald sold his idea to Paramount in 1983, and the film was not shown in theaters until 1988.

an overhead pool and perhaps amortized against several other films over a period of years. Since the cost of the abandoned project is expensed against other films, the user might not be able to accurately correct her prior expectation. Therefore, as shown by this case, the PSOP has more feedback value.

### *Verifiability*

Verifiability is the first ingredient of reliability, and to compare the reliability of the information provided by the two standards, I will use an example based on ultimate gross revenue projections. FAS 53 allows revenues from peripheral items such as toys and clothing to be included in gross revenue projections. Even uncertain items such as amusement park rides can be included in the revenue estimates. This, obviously, gives management greater freedom in developing its revenue projections. As management bias may be included in the revenue projections, it also may be difficult for individual users to arrive at the same conclusion. However, under the PSOP, ultimate revenue projections cannot include revenues from the sale of peripheral items. Each user of this financial information clearly knows what is and what is not included in the projections, and individual users are more likely to arrive at the same conclusion. On the other hand, Disney consistently under-projects revenues from peripheral items, meaning the “profits Disney is currently showing on its megahit films could be way too low” (Atlas 62).

### *Representational Faithfulness*

Both motion picture accounting standards will result in information that contains representational faithfulness. For example, some accountants may argue that an abandoned project is indeed a loss and therefore should be charged to the current period's

income statement, which the PSOP requires. On the other hand, some accountants may argue that an abandoned project is more like a cost of doing business, and therefore should be allocated to the overhead pool, as required by FAS 53. A similar argument can be made for advertising costs. A decision-maker who believes that exploitation costs in the motion picture industry are no different than advertising costs in any other industry, would most likely agree with the PSOP and think that the costs should be expensed when incurred, as consistent with SOP 93-7. However, a decision-maker who believes exploitation costs are no different from any other production cost in the motion picture industry, would most likely agree with FAS 53 and think the costs should be capitalized. Therefore, it is difficult to draw a conclusion on which standard results in information with more representational faithfulness<sup>8</sup>. Likewise, it appears that both standards contain neutrality, meaning that neither was written with a biased purpose, such as a lower tax burden.

### *Comparability*

Comparability, although considered to be a secondary quality of accounting information, has become one of the main reasons for the support in favor of the PSOP. Significant variations in the application of FAS 53 and as manipulations of the statement by led to certain companies' failures, are both cited as reasons why the PSOP was written (PSOP ¶2). Additionally, Harold Vogel talks about the lack of consistency often attributed to FAS 53: "Yet the statement [FAS 53] has nevertheless drawn criticism for

---

<sup>8</sup> David Solomons notes: "A high degree of market association is evidence that the criterion [of representational faithfulness] is being met...a potential method [in this case, PSOP] cannot be implemented and therefore cannot be tested" (211).

allowing considerable discretionary variation in the treatment of marketing and inventory cost amortization in particular... Thus, under 53, there is ample room for substantial variation in earnings reporting practices to appear” (99-100). The PSOP provides more comparability by requiring that all companies use the same amortization period and include the same items in ultimate gross revenue projections.

On the other hand, by requiring the same treatment by all companies, the PSOP might also reduce comparability. For example, consider two motion picture companies that are producing two very different films. One has a film that is likely to include millions of dollars of sales from peripheral items, and revenue streams from the film are expected to occur over the next twenty years. The other company’s film will sell no peripheral items and its revenue streams will last the next ten years. Yet both firms must amortize their costs over ten years, and are prohibited from including revenues from the peripheral items in their projections. Despite the fact that they are using the same treatment, it will be difficult to compare their financial results because their situations are so different.

Although an entertainment company’s financial statements would not be consistent in the year that a change from FAS 53 to the PSOP occurred, “accounting progress is impossible without some loss of consistency” (Solomons 185). However, once implemented, the PSOP would provide more consistency than the FAS 53. Not only did variations in earnings occur between different companies, but significant variations also occurred within a company from one year to the next. For example, in the late 1980s and early 1990s, Orion Pictures would frequently change its accounting

methods, while still remaining in the confines of FAS 53: “They [were] supposed to capitalize and write down the amount at regular intervals and subtract this number from earnings if the box-office outlook deteriorates. Orion would delay, sometimes for years, write-downs with the hope that a string of smash hits would rescue it from its growing debt load” (Grover 56). As a result of this technique, the amount of the company’s loss from write-downs would vary from year to year, depending on the success or failure of the other films released in that year.

### *Conservatism*

Based on the above examples, it should be clear that the PSOP calls for much more “conservative” accounting than FAS 53. For example, the PSOP states that revenue from the licensing of a film can only be recognized when the film is delivered and all modifications are complete. However, under FAS 53, the point where revenue is considered to be earned, and therefore should be recognized, is at the time of the signing of the contract and the delivery of the film. Changes such as dubbing, subtitles, or adding footage—even if as part of the contract—are not considered significant enough to postpone revenue recognition. However, conservatism may actually decrease the reliability of accounting information by delaying recognition of income into later periods. Therefore, the fact that the PSOP is more conservative and limits management’s creativity does not necessarily make the standard better than FAS 53. In fact, David Solomons maintains that “the greatest danger accounting standards pose is to innovation in financial reporting” (223).

## **Hypotheses**

Based on the examination of the two standards, I have formed the following hypotheses, as stated below, which relate to specific points of difference between FAS 53 and the PSOP:

**Hypothesis H<sub>1</sub>: Exploitation costs should be expensed as incurred, as provided by the PSOP.**

**Hypothesis H<sub>2</sub>: The costs of abandoned projects should be charged to the current period's income statement, as required by the PSOP.**

**Hypothesis H<sub>3</sub>: Revenue from licensed films should not be recognized until modifications to the films are complete, as required by the PSOP.**

**Hypothesis H<sub>4</sub>: Ultimate gross revenue projections should not include revenues from the sale of peripheral items, as required by the PSOP.**

**Hypothesis H<sub>5</sub>: The maximum period of amortizing production costs should be ten years, as required by the PSOP.**

Finally, the following hypothesis was formed based on the overall differences between the PSOP and FAS 53:

**Hypothesis H<sub>6</sub>: The PSOP is a better accounting standard than FAS 53.**

The formation of the hypotheses was a result of my belief that the PSOP takes some of the uncertainty out of the reported net income number. As the PSOP requires more conservative ultimate gross revenue projections than FAS 53, and thus lowers the risk of manipulation in income, I think external users will tend to prefer this standard.

## Qualities of Good Accounting Standards

In addition to an examination of how the information provided by each motion picture accounting standard fits the characteristics of relevance and reliability, the quality of the standard can also be judged by comparing it to other accounting standards. A study by Cheri Reither had participants at the 1996 American Accounting Association/ Financial Accounting Standards Board (AAA/ FASB) Financial Reporting Issues Conference complete a survey rating the best and worst accounting standards, and this study supports Hypothesis H<sub>6</sub>—that the PSOP is the higher quality accounting standard. FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, was rated as the overall best accounting standard, with a primary reason being that “the FASB [successfully] conquered a problem in need of a solution” (Reither 285). Similarly, the PSOP for motion picture accounting solves the problem that exists under FAS 53—the ability to over-report income that companies such as Cannon Group and Orion Pictures abused.

### *FAS 95*

FAS 95, *Statement of Cash Flows*, was also rated as one of the best accounting standards, with the primary reason that it provides a standardized way of reporting, resulting in more consistency and comparability. As the PSOP would provide a more standardized way of reporting than that provided in FAS 53, Hypothesis H<sub>1</sub> is further supported. For example, the PSOP requires that capitalized costs be amortized over a period not to exceed ten years, and also excludes peripheral items from being included in ultimate gross revenue projections.



## *FAS 5*

FAS 5, *Accounting for Contingencies*, was also listed as one of the best standards. One of the explanations given was that the standard is “not too complicated and provides general guidelines, requiring reasonable management” (Reither 286). FAS 53 actually appears to give “more general guidelines” than the PSOP, as FAS 53 prescribes general rules for what to include in ultimate gross revenue estimates. Another main reason that FAS 5 was rated so highly is also because it reduces the smoothing of earnings.<sup>9</sup> As one of the main reasons behind the issuance of AcSEC’s PSOP was to do this very thing, as well as reduce earnings manipulations, it appears that Hypothesis H<sub>6</sub> is further supported, although a conclusion cannot yet be drawn without any statistical data.

## *FAS 87*

Further support for Hypothesis H<sub>6</sub> can be found in FAS 87, *Employers’ Accounting for Pensions*. One of the reasons for this standard’s high rating is that it was a “reasonable evolutionary step in pension accounting” (Reither 287). As described earlier, with the introduction of new and expanding markets for motion picture films, the process of estimating ultimate gross revenue projections under FAS 53 appears outdated. The PSOP takes the expanding markets and other changes in the motion picture that have occurred in the last fifteen years into account, and therefore it can similarly be considered a “reasonable evolutionary step” in motion picture accounting.

---

<sup>9</sup> “As it eliminates the free choice for when to record a liability for a loss contingency” (Reither 286).

## **Qualities of Bad Accounting Standards**

The same study that rated the best accounting standards also rated the worst standards. FAS 13, *Accounting for Leases*, was considered one of the worst standards. One of the main reasons for its poor ranking was because its “bright-line rules for lease capitalization result in abuse of standard” (Reither 288). As already mentioned, the abuses that have occurred under FAS 53 are one of the largest criticisms of the statement. Both Cannon Films and Orion Pictures abused the standard and were able to over-report income. Since the PSOP has not been implemented, we cannot say for sure that the statement will not be abused; however, since one of its primary purposes is to prevent the abuse that occurred under FAS 53, I believe that it will be an improvement.

## **CHAPTER 3**

### **RESEARCH METHODOLOGY**

#### **Introduction**

Although I have established the groundwork for why theoretically, the PSOP is a higher quality accounting standard than FAS 53, I will test the hypotheses by asking users of financial statements for their opinions regarding the standards. To the extent that the user groups answer, their responses can be used as support for or against the hypotheses. I sent a survey to three different groups of users—public accounting professionals, industry professionals, and accounting professors. These three groups were chosen as target groups because I think that they may have differing opinions on the issue, and are the most likely user groups to be familiar with the topic.

#### **Survey Respondents**

##### ***Three Groups***

As accounting for motion pictures is a highly specialized topic, it was necessary to send the surveys to groups that I thought would have some knowledge and interest in the area. In order to understand the changes in the PSOP, a person must have a thorough knowledge of a highly technical topic as well as two industry specific standards,

including one that is not yet in effect. One of the primary difficulties in sending out a survey on this topic, therefore, is getting people to respond. While it would be difficult to pre-screen respondents regarding their knowledge about accounting for motion pictures, I did attempt to send the surveys to people who I thought would be more likely to have a thorough knowledge on the topic. 150 surveys total were sent out, fifty to each user group. The public accountants were chosen from a list of Big Five managers and partners with some experience in the entertainment industry. The list of industry professionals specifically in the motion picture industry was also obtained from a Big Five accounting firm. Finally, the accounting professors were chosen based on their location, with the assumption that those teaching near the Los Angeles area (where each of the seven major movie studios are located) may be more familiar with or have had more experience with issues pertaining to motion picture accounting.

### *Risk in Selections*

There is high risk inherent in my selections. First, as previously mentioned, accounting for motion pictures is a highly technical topic. This means that not only would someone have to be familiar with the topic, but in order to respond, he or she would also have to be interested in the topic. There might not be much incentive in responding to the survey if users do not feel the changes in the PSOP will affect them. This may be evidenced by the fact that the AICPA has historically had low response rates on issues dealing with motion picture accounting. When SOP 79-4, *Financial Accounting and Reporting by Producers and Distributors of Motion Picture Films*, was issued, only 23 comment letters were received. Additionally, only 28 comment letters

were received for the PSOP. Compare this to the 1,400 responses received for the exposure draft regarding accounting for phase-in plans, abandonments, and disallowments, the 882 responses for the exposure draft on accounting for nonrefundable fees and costs associated with originating and acquiring loans, and more recently, the 281 responses on the comprehensive income exposure draft. Additionally, as I am sending these to professionals at a high level in a company and there is not much incentive to answer, the respondents may not have enough time. Specifically in the case of the public accountants, the surveys were mailed out in the middle of January, which is during their busy season. Despite the potential difficulties with response rate, I felt that surveys would be the most effective way to gather data with which to test the hypotheses.

## **Survey Design**

### *Format of Survey*

The survey is a one-page, dual-sided questionnaire set up in three parts. (See Appendix C for a copy of the survey.) The first part asks the respondents for their opinions on some general topics in accounting, the second part relates specifically to accounting for motion pictures, and the third gathers some limited demographic data on the respondents. I chose to use a fixed-response survey (rather than an open survey where respondents were free to respond as they pleased) primarily for purposes of the respondents' ease in answering the questions, and my ease in compiling the data. For the first two parts, respondents were asked to express their opinions by selecting the extent to which they agreed with the statement, using a five-point scale set up as follows:

1	2	3	4	5
Disagree	Somewhat disagree	Neither agree nor disagree	Somewhat agree	Agree

This scale is a Likert-type rating scale, and is used to measure attitudes (Thomas 23).

A five-point rating scale presents an interesting dilemma for some people because it allows a middle answer. Allowing a middle answer effectively reduces the sample size and the representativeness for the item, and although “most survey investigators are willing to allow a don’t know [or middle] response, they usually do so with considerable reluctance” (Schuman and Presser 8). However, in the case of this particular survey, I believe that there may be instances in which the respondent truly does not agree or disagree with the statement. Therefore, by not allowing a middle response, I would skew the data by forcing the respondent to pick a side on an issue, a side with which he or she might not actually agree. Schuman and Presser offer additional support for the use of the middle answer in surveys. They argue that the middle answer has an important meaning in survey data:

Much error in survey data flows from random responses by persons who really have no views on the issues under inquiry and simply flip mental coins in order to satisfy the interviewer’s expectation of an answer. It also seems quite possible that respondents who lack opinions on an issue will be especially susceptible to various response sets, thus contributing systematic as well as random error to survey data...Respondents should be allowed, perhaps even encouraged, to see DK [don’t know, or middle answer] as a legitimate response in attitude surveys (114).

### *Focus of Survey*

Although the PSOP brings in changes that affect a number of areas, to maintain the one-page format of the survey, income recognition, composed of revenue recognition

and expense matching, was chosen as the main focus. There are three primary reasons for my choice of income recognition as the main topic. The first is that differences in methods of income recognition between companies under FAS 53 is one of the main criticisms of the statement, and hence is the area where the largest changes are proposed.

The second reason for the focus on income recognition relates to the importance that users of financial information place on income. David Solomons asserts that “how profit should be measured is, and always has been, the most controversial question in accounting” (6). He further notes that users need information to form expectations about the future, and the most useful information to help them in this process is earnings: Earnings “conveys information about the success of the ventures that have been invested in and also about the performance of managers who have been responsible for running the business” (90). Even SFAC 1 discusses the importance of the income number to users. This statement argues that management’s primary responsibility lies with earnings; hence, the performance of management is closely related to increases or decreases in earnings (§52).

Finally, the third reason that income recognition was chosen as the main focus is the importance that the SEC has recently placed on revenue recognition<sup>10</sup>. Barr, in discussing the SEC’s efforts to end selective disclosure, refers to the proposed rules as “yet another front in the battle by SEC chairman Arthur Levitt to combat ‘misleading’ financial reporting” and describes Levitt’s campaign “against companies that use

---

<sup>10</sup> “Levitt has called for ‘immediate and coordinated action’ among accounting rule makers—including the SEC, FASB, and AcSEC to improve the transparency of financial statements in general. He has criticized ‘accounting hocus-pocus’ designed to boost earnings” (Berton and Harris 46). Consider SEC Staff

accounting gimmicks to meet analysts' earnings estimates" (54). Another article describes Levitt's focus on revenue recognition in this way: " 'Think about a bottle of fine wine,' Levitt said. 'You wouldn't pop the cork on that bottle before it was ready.' However, he said some companies were essentially doing that, recognizing revenue before the sale was complete when the customer still had the option to void or delay the sale" (Illusions 12). Levitt has even said that his staff will determine whether the new standards for the software industry can be applied to other service industries, and this of course is likely to include the entertainment industry (Berton and Harris 46). Therefore, income recognition is a "hot topic" and perhaps will be interesting to the survey respondents.

### *Question-Order Effect*

The first section of the survey, which asks questions about revenue recognition but does not specifically refer to motion pictures, consists of nine questions. Each question is set up to have at least one "check" question. That means that for each answer a respondent gives to an individual question, there is/are another question/s that the respondent should answer in a certain way if his or her thinking is consistent. This setup was used to check for any question-order effect, which means that a response may in fact be partly or entirely due to question order. Schuman and Presser note that question-order effects are the most frequently offered explanation for an unexpected or unreplicated survey finding, besides sampling error (24). Although the frequency of question order effects is unknown, as "virtually all question-order effects involve two or more questions

---

Accounting Bulletin 101, *Revenue Recognition in Financial Statements* as proof of the SEC's recent focus on revenue recognition.



that deal with the same or similar issues,” this survey was set up to ask two or more questions that deal with a similar issue to identify this effect.

### *Successful Efforts*

In addition to asking two or more questions that deal with a similar issue, the first section indirectly relates to motion picture accounting, in that it refers to revenue recognition or expense matching. For example, the first statement on the survey states “Oil and gas production companies should use the full cost method instead of the successful efforts method, and capitalize all costs of exploration and development, whether successful or not.” Currently, oil and gas companies have two options: the full cost method, which capitalizes all costs associated with production, and the successful efforts method, which only capitalizes the costs associated with locating the productive wells, with the remainder of the costs written off to the income statement.

This issue is similar to the overhead pool concept used in motion picture accounting. Under FAS 53, motion picture production companies can allocate the costs of all unsuccessful or abandoned projects to a pool, which is capitalized and then amortized against future films’ revenues. This method is similar to the full cost method for oil and gas production companies. However, the PSOP takes an approach similar to the successful efforts method—it requires that the loss from abandoned projects be taken as a charge against income in the current period. Therefore, even if a respondent is not familiar with motion picture accounting, I can interpret which method he or she would prefer by the way he or she answers the first question. Additionally, I can assume that he or she will most likely answer this statement in the same way that he or she answers two

statements in the second section: question 12, which states “Any loss resulting from a project that is dropped should be allocated to the producer’s overhead pool” and question 15, “When a producer abandons a script, the resulting loss should be recognized in this period’s income statement.”

### *Advertising Costs*

The second question in the first section states “Intangible costs associated with opening a new business should be capitalized and amortized over time.” Some characteristics of an intangible asset are described in APB No. 17: “lack of physical qualities, value is often difficult to estimate, and its useful life may be indeterminable” (§2). GAAP allows organizational costs, or those incurred during the organization of an enterprise, to be capitalized as intangible assets and amortized over a period not to exceed 40 years. Therefore, it can be assumed that by calling these organizational costs “intangible assets,” as consistent with the definition of an asset, the costs will provide future economic benefits. However, not all cash outflows that result in the creation of an intangible asset are capitalized under GAAP. For example, research and development costs (R&D) and advertising costs are both expensed as incurred<sup>11</sup>. This is due to the uncertainty that the expenses will indeed directly result in the creation of an asset that will provide future benefits. Included for the purpose of being a check on a respondent’s consistency is question 6, which states “Current GAAP, which requires advertising costs to be expensed as incurred, is sound accounting.” A respondent should be consistent in his or her belief that these cash outflows either do or do not result in an asset that will

---

<sup>11</sup> See FAS 2, *Accounting for Research and Development Costs* and SOP 93-7, *Reporting on Advertising Costs* for exceptions.

benefit future periods; yet it is realized that this statement is not a perfect check, as a respondent might honestly believe that organizational costs do result in the creation of an intangible asset and that advertising costs do not.

Both of the above statements relate to question 10, which states “Promotional costs, such as the cost to run advertisements on television, should be expensed as incurred” and to question 13, “Given advertising is a crucial component of a successful film, these costs should be capitalized.” Under FAS 53, exploitation costs, which include rents, salaries, prints and advertising and payments of subdistribution fees, can be capitalized as assets (film-cost inventory) if they are believed to benefit future periods. They are subsequently amortized over a period in which the major portion of gross revenue is recorded. The amounts capitalized, particularly for national advertising, can be considerable (Vogel 99). However, the PSOP requires the motion picture industry to be consistent with most other industries and expense advertising costs as incurred. It may be noted that the PSOP originally allowed pre-release and early release exploitation costs to be capitalized and amortized over a period not to exceed three months—which is a practice currently followed by Disney and Universal—but the SOP was changed and now requires that all exploitation costs be expensed as incurred.

#### *Amortization Period*

The third statement in the first section of the survey reads “Purchased goodwill should always be amortized over 40 years.” This question is intended to discern a respondent’s opinion on whether assets should be amortized over a prescribed amount of time or over the asset’s economic life. GAAP sets 40 years for the amortization of

goodwill—a time period some accountants think is arbitrary and thus meaningless, but others think is necessary for the purpose of conservatism. Similarly, GAAP provides amortization periods for such purchased intangible assets as patents, licenses, and copyrights. Thus, question 7 serves as a consistency check for question 3: “Intangible assets, such as trademarks and trade names, should be amortized over their economic lives regardless of their legal lives.”

This same concept, as it specifically relates to accounting for motion pictures, is tested in the second section of the survey. The PSOP requires that capitalized production costs be amortized against the revenue stream of a film, as long as that period does not exceed ten years. On the other hand, under FAS 53, capitalized production costs could be amortized against the entire revenue stream, regardless of the length of time this took. Therefore, both question 17—“Capitalized production costs should be amortized against the entire revenue stream of the film”—and question 19—“Capitalized production costs should be amortized against the revenue stream of a film, but should not exceed ten years”—relate to this issue.

### *Revenue Recognition*

There are three questions in the first section of the survey that specifically relate to the timing of revenue recognition. SFAC 5 describes the two conditions that are necessary for revenue to be recognized—they must be earned and realizable:

Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues...Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that

can rapidly absorb the quantity held by entity without significantly affecting the price” (§83).

Revenues are generally considered to be earned when some “critical event” occurs, while realizability is considered to have occurred when the amount of revenue can be reasonably measured. As stated in APBS No. 4, “revenue is sometimes recognized on bases other than the realization rule...This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results” (§16). Two examples of exceptions to this realization principle are the percentage-of-completion method for construction contracts and recognizing revenue for precious metals at the completion of production.

Question 9 on the survey relates to the percentage-of-completion method and states, “Construction companies should recognize revenue using the completed contract method rather than the percentage-of-completion method.” Under the percentage-of-completion method, income is recognized as work on the contract progresses, while under the completed contract method, income is not recognized until all of the work has been finished. The percentage-of-completion method relies on estimates of ultimate contract costs, which is not unlike the estimates of ultimate gross revenues that are used to recognize expenses in motion picture accounting.

Question 4, which states “Because certain precious metals have a fixed selling price, revenue should be recorded at the end of the production process, even though additional selling and delivery work may be necessary” also relates to the concept of revenue recognition. As precious metals have a fixed determinable monetary value with

no substantial cost of marketing, the earning process is thought to be complete when production is complete. This means that no sale has been made, no cash has exchanged hands, and yet revenue can be recognized. This is similar to the concept of recognizing revenue when a motion picture film is delivered. Under FAS 53, a film producer could recognize revenue as soon as the contract existed and the film was delivered, even if modifications were yet to be completed. For example, a producer could recognize revenue even if it still needed to add footage, add subtitles, or edit content, as required by the contract. This concept is addressed in the survey with questions 11 and 14, respectively: “Revenue should be recognized only when the film is delivered AND all modifications such as the addition of content are complete” and “Revenues should be recognized when a contract exists and the film has been delivered, regardless of whether changes to the film, such as dubbing, must be made.”

The last question on the survey that addresses the timing of revenue recognition is question 8: ‘Revenue should be recognized when the seller is no longer exposed to the risk of return of the property.’ FAS 48, *Revenue Recognition When Right of Return Exists*, says that if certain conditions are not met, “revenue must be recognized when the return privilege has substantially expired or when these conditions are subsequently met” (§6). One of the included conditions is that “the seller does not have significant obligations for future performance to directly bring about the resale of the product by the buyer” (§6). As mentioned above, under FAS 53, revenue can be recognized even if the seller has obligations for future performance<sup>12</sup>.

---

<sup>12</sup> Some accountants may not feel these modifications are “significant,” and thus should not preclude revenue recognition anyway.

### *Ultimate Gross Revenue Projections*

The final question in the first section is question 5: “In preparing a cash flow analysis to be used in a capital budgeting decision, cash flow streams that are largely uncertain should be included.” This question is intended to relate to the uncertainty included in deciding what type of items to include in a motion picture’s ultimate gross revenue estimates. FAS 53 allows for great variation in what is included in the projections, as it does not specifically state what can and cannot be used. The PSOP attempts to stop some of this variation by requiring that ultimate gross revenue projections not include “revenues from the entity’s manufacture and sale of peripheral items, such as lunch boxes, toys, tee shirts, and so forth” (§29). Estimates from any revenue that may result from these items are, in most cases, highly uncertain. Question 16, which states “Revenues from promotional items such as toys should be included in the ultimate gross revenue projections for a film, and question 18, “Ultimate gross revenue projections should not include revenue from largely uncertain items such as theme park rides,” both refer to this issue.

### *Demographic Questions*

The last section of the survey asks a series of demographic questions, to gain a general understanding of the background of the respondents. The first two questions in this section ask the respondents to answer whether they are familiar with the accounting procedures in FAS 53 and in the PSOP. If the respondents circle “yes” to both of these questions, they were instructed to proceed to the question immediately following, which asks, “Which standard do you think would result in better accounting information?”

They can then express their opinions on the major problem areas with each standard. All respondents are then asked to circle their years of experience in each of the three areas—teaching, public accounting, and industry—as well as the number of years spent in the entertainment industry. I did not need to ask what the respondent was currently working in, as I color-coded the surveys when I sent them out. CPAs were sent gray surveys, industry professionals tan surveys, and professors yellow surveys.

The penultimate question asks the respondents' sex, which will be used in determining if the survey has any nonresponse bias (I can compare the proportion of surveys sent to females with the proportion of responses from females). Finally, the last question, which asks if the respondent would prefer a vacation to New York or Las Vegas, was an attempt to gain a little insight into the respondent's risk preference. I assumed that a person wishing to travel to New York would be risk averse, while one choosing Las Vegas would be a risk seeker. As the PSOP dictates more "conservative" requirements, and does not allow "risky" items such as theme park revenues to be included in revenue projections, I thought that perhaps a respondent who preferred the PSOP would also prefer a trip to New York.



## **CHAPTER 4**

### **DATA ANALYSIS AND RESULTS**

#### **Introduction**

In order to obtain data from actual users of financial statements, I developed a survey. The survey consisted of three parts: a section that asked questions regarding accounting topics in general, a section that asked specific questions about motion picture accounting, and a section that asked demographic questions. (The survey can again be seen in Appendix C.) 150 surveys were mailed to individuals in three groups—entertainment professionals, public accountants, and university accounting professors. Of the 28 questions on the survey, the first nineteen ask the respondent to rate the extent to which he or she agrees with the statement, while the last nine ask for demographic data. Extreme answers on these nineteen questions are intended to reflect a choice for either FAS 53 or the PSOP; for example, the choice of “5” on question one indicates the respondent’s strong preference for FAS 53, while an answer of “1” indicates a strong preference for the PSOP.

## **Response Rate**

The 150 surveys were mailed out in the middle of January with a requested return date of March 27. Seventeen responses were received, for a total response rate of 11.33%. No follow-up mailing or contact was done. One of the responses was a letter from an executive at Viacom, one of the country's largest entertainment companies and the parent company of Paramount Pictures, which stated that due to confidentiality and time reasons, the executive would be unable to respond to the survey. Therefore, there were sixteen usable responses. Of these sixteen returned surveys, two were from individuals in the entertainment industry, five were from university professors, and nine were from public accountants.

Although I thought that a survey was the most effective and efficient way to gather the necessary data to test my hypothesis, I did not expect a high response rate. Accounting for motion pictures is a highly specialized topic, and it is therefore difficult to determine which individuals will have technical knowledge about and interest in the subject. Additionally, the professionals who are most likely to possess this technical knowledge are often in a high level in the organization, meaning they are also the least likely to have available time to complete the survey. As described in Chapter 3, I was aware of the risk of a low response rate, but I was willing to accept this risk and send the surveys to those I thought would be most likely to be knowledgeable on the topic. I ended with a response rate of 11.33%.

## **Nonresponse Bias**

Because of the low response rate, there is concern over the possibility that the sample possesses nonresponse bias. Nonresponse bias refers to the bias that the results may have when extrapolated to the entire population based on the low response rate. To test for obvious bias, I compared the demographics of the respondents with the demographics of the population. This was done on the basis of sex, as this was the only demographic factor that we knew for the entire sample—53 of the surveys, or 35.33%, were sent to women. The proportion of females responding was .4286, with a 99% confidence interval of (.1766, .7114), which is fairly close to the proportion of females in the population. Therefore, although there is still concern over nonresponse bias, we can assume no nonresponse bias for the purposes of examining the statistical results.

## **Cronbach's Alpha**

As discussed in Chapter 3, each question was written with at least one “check” question, meaning that for each answer a respondent gives to an individual question, there is/are another question/s that the respondent should answer in a certain way if his or her thinking is consistent. This setup was used to check for any question-order effect, which means that a response may, in fact, be partly or entirely due to question order. Each question can then be grouped with its “check” questions, resulting in the formation of five groups thought to be measuring similar components of the standard. The questions included in each group are listed in Table 4.1 below:

Table 4.1: Consistency Groups

<b>Group One</b>	Question 1	Question 12	Question 15		
<b>Group Two</b>	Question 2	Question 6	Question 10	Question 13	
<b>Group Three</b>	Question 3	Question 7	Question 17	Question 19	
<b>Group Four</b>	Question 9	Question 4	Question 8	Question 11	Question 14
<b>Group Five</b>	Question 5	Question 16	Question 18		

To test the reliability of the items that make up the five groups, Cronbach's alphas were calculated. Cronbach's alphas estimate the reliability between two or more items and the test is "often considered a relatively conservative estimate of the internal consistency of a test" (Arsham 34). The Cronbach's alphas for all five groups are listed in Table 4.2 below:

Table 4.2: Cronbach's Alphas

Group One	.5641
Group Two	.7658
Group Three	.5176
Group Four	.3868
Group Five	-1.4063

Although the Cronbach's alphas for Groups One and Three indicate a positive correlation, only the questions in Group Two appear to be highly correlated. Therefore, I

decided to perform the data analysis on each individual question instead of on the group averages since most of the groups did not show a high correlation.

### **Wilcoxon Signed Rank**

Because the individual questions were to be analyzed instead of the group averages, each of the nineteen survey questions had to be oriented in the same direction. Each question was, therefore, realigned so that a high score suggests a preference for the PSOP. Pictorial representations of the distribution of answers for each question, or histograms, can be seen in Appendix D. For each question, three hypotheses were set up:

$H_a: \mu = \mu_0$       If the median score equals three, there is no preference for either standard.

$H_a: \mu > \mu_0$       If the median score is greater than three, the preference is for the PSOP.

$H_a: \mu < \mu_0$       If the median score is less than three, the preference is for FAS 53.

Wilcoxon signed-rank tests were then used to test the hypotheses. The Wilcoxon signed-rank test was used rather than the  $t$  test because it performs better when the underlying distribution has “heavy tails”, meaning that the “observed values lying far from  $\mu$  are relatively more likely,” which is likely to be the situation (Devore 636). As we cannot assume this data to have a normal distribution (because of the likelihood of “heavy tails”) the Wilcoxon signed-rank test seems the best method. Additionally, the Wilcoxon signed-rank test is believed to be just as efficient as the  $t$  test, and it “never gives up very much to the  $t$  test and may be a distinct improvement on it, so if there is much doubt about the assumption of normality, the Wilcoxon test provides a good

alternative means of analysis (Devore 643). The results of the Wilcoxon signed-rank test can be seen in Table 4.3 below:

Table 4.3: Wilcoxon Statistics and Estimated Medians

Question	N for Test	Wilcoxon Statistic	P	Estimated Median
1	11	26.0	0.563	3.00
2	15	32.5	0.125	2.50
3	13	15.5	0.039	2.00
4	14	45.0	0.660	3.00
5	13	66.0	0.162	3.50
6	15	85.5	0.156	4.00
7	15	15.0	0.011	2.00
8	14	41.0	0.490	2.50
9	12	3.0	0.005	2.00
10	15	62.0	0.932	3.00
11	15	96.0	0.044	4.00
12	14	68.5	0.331	3.50
13	16	58.0	0.623	3.00
14	12	60.0	0.328	3.50
15	14	72.0	0.233	4.00
16	14	34.0	0.258	2.50
17	15	11.0	0.006	2.00
18	16	123.0	0.005	4.50
19	14	71.0	0.258	3.50

The first column in the table above represents the number of the question on the survey.

The next column, “N for Test,” indicates the number used for the test, and was calculated by taking the number of responses to the question less the number of “3” responses, as middle answers are not included in the Wilcoxon Statistic.

## P-Value

P-value is defined as “the smallest level of significance at which  $H_0$  would be rejected when a specified test procedure is used on a given set of data” (Devore 334). In other words, the P-value is compared to a level of significance, and if the P-value is lower, the null hypothesis can be rejected and the test is not statistically significant. To calculate the P-value for my data, two types of Bonferroni adjustments were made. Bonferroni adjustments are used to control for multiple comparisons. As the data sample is assumed to be nonparametric, (non-normal distribution), the adjustments control for simultaneous testing of questions. The more stringent comparison would be to use  $.05/19 = .0026$  as the level of significance with which to compare the P-values, which would control the experimental error rate for all nineteen questions to .05. However, this appears to be too conservative as none of the P-values in the above chart fall below this number, and therefore I used an alternative Bonferroni adjustment. The alternative is to control the error rate for each group (i.e. Group One – Group Five) separately. The calculated P-values for each group are shown in Table 4.4 below:

Table 4.4: P-values

Group One	.05/3	.017
Group Two	.05/4	.0125
Group Three	.05/4	.0125
Group Four	.05/5	.01
Group Five	.05/5	.017

## Results

Keeping in mind that a higher score indicates a preference for the PSOP, we can analyze the estimated medians to determine which standard is preferred. If the median is less than 3.00, there is a tendency to prefer FAS 53, and if the median is greater than 3.00, there is a tendency to prefer the PSOP. Additionally, by comparing the levels of significance calculated using the second Bonferroni simultaneous testing procedure to the P-values listed in Table One, we see that questions 7, 9, 17, and 18 are all statistically significant.

### *Exploitation Costs*

As required for most industries in SOP 93-7, advertising costs are to be expensed as incurred. However, under FAS 53, advertising costs are allowed to be capitalized when they clearly benefit future periods, as is the case with national advertising. In the PSOP, advertising costs are required to be expensed as incurred, requiring the motion picture industry's treatment of these costs to be consistent with that of other industries. Four of the questions on the survey—the four in Group Two—relate to the issue of advertising costs.

Question 6, “Current GAAP, which requires advertising costs to be expensed as incurred, is sound accounting,” has an estimated median of 4.00 (a score above 3.00 indicates preference for the PSOP), while question 2, “Intangible costs associated with opening a new business should be capitalized and amortized over time” has an estimated median of 2.50 (a score below 3.00 indicates a preference for FAS 53). Both of these questions, while not specifically related to the motion picture industry, are attempts to



discern the respondent's opinions on advertising costs. As the respondents agreed that advertising costs should be expensed as incurred, but that organizational costs should be capitalized, it appears that they were making their judgment based on whether the costs provided any future economic benefits. The respondents apparently believe that organizational costs benefit future periods, while costs of advertising do not.

Questions 10 and 13, which relate directly to advertising costs in the motion picture industry, have estimated medians of 3.00, indicating no preference for the treatment required by either accounting standard. As respondents previously indicated a preference for expensing advertising costs, one would have expected that they would have preferred the PSOP. However, as I have already stated, the respondents apparently were basing their decision on whether the costs benefited future periods. Question 13 states, "Given advertising is a crucial component of a successful film, these costs should be capitalized." Thus, the respondents were told that the costs *would* benefit future periods, which was likely to bias their opinions on expensing advertising. Additionally, Question 10 refers to promotional costs, and uses television advertisements as an example. This statement does not indicate whether the advertisements were local (and therefore not likely to benefit future periods) or national (generally considered likely to benefit future periods).

### *Abandoned Projects*

In motion picture accounting, certain production costs are allocated to an overhead pool which is then amortized over several films in several periods. Under FAS 53, the costs associated with an abandoned project are simply allocated to this overhead

pool. Conversely, the PSOP requires that any loss resulting from an abandoned script or project be recognized in the current period's income statement. Question 12 on the survey, "Any loss resulting from a project that is dropped should be allocated to the producer's overhead pool" shows an estimated median of 3.50. Similarly, Question 15, "When a producer abandons a script, the resulting loss should be recognized in this period's income statement" shows an estimated median of 4.00. Therefore, in both instances, respondents' indicated a preference for recognizing the losses in the current period, as required by the PSOP.

Another question which relates to allocating losses to the overhead pool is Question One which states, "Oil and gas production companies should use the full cost method instead of the successful efforts method, and capitalize all costs of exploration and development, whether successful or not." The oil and gas industry is similar to the motion picture industry in that it may take many unsuccessful drilling efforts ("box office flops") before a valuable one is found (a "box office blockbuster"). However, the estimated median for Question One was a 3.00, thereby indicating no preference for either the full cost method or the successful efforts method. The fact that the respondents did not indicate a preference for either method is likely due to the fact that they were influenced by the knowledge that either method is acceptable under GAAP. Nonetheless, based on the results from Questions 12 and 15, we can infer that the preference is to recognize losses from abandoned projects in the current period's income statement.

## *Revenue Recognition*

Question 9, with a P-value of .005, is statistically significant. This question, “Construction companies should recognize revenue using the completed contract method rather than the percentage-of-completion method,” relates to the concept of revenue recognition. Revenues are generally considered to be earned when some “critical event” occurs, while realizability is considered to have occurred when the amount of revenue can be reasonably measured; however, the percentage-of-completion method for construction contracts is an exception to this realizability principle. Under the percentage-of-completion method, a company recognizes income as work on the contract progresses. Revenue recognition, particularly regarding the licensing of films, is one of the main differences between FAS 53 and the PSOP. FAS 53 considers the “critical event” for revenue recognition to be the moment a producer delivers a licensed film. On the other hand, the PSOP relies on the realizability principle, and delays revenue recognition until modifications and additions to the film have been completed; delivery of the film is not enough to allow revenue recognition.

The remaining questions in Group Four also relate to the timing of revenue recognition. Question 4 states, “Because certain precious metals have a fixed selling price, revenue should be recorded at the end of the production process, even though additional selling and delivery work may be necessary.” This question indicates that the production of precious metals is the “critical event,” as precious metals have a fixed determinable monetary value with no substantial cost of marketing. With the estimated median of 3.00, however, no preference is indicated. However, Question 8, “Revenue

should be recognized when the seller is no longer exposed to the risk of return of the property” does indicate a preference, with an estimated median of 2.50. As FAS 53 allows revenue recognition before modifications are completed (and thus, before the seller is no longer exposed to the risk of return), responses to this question may indicate the respondents have a preference for the revenue recognition methods under FAS 53.

Despite the support of Question 8 for FAS 53, responses to two other questions on the survey indicate a preference for the PSOP regarding revenue recognition. Question 11 states, “Revenue should be recognized only when the film is delivered AND all modifications such as the addition of content are complete.” The estimated median of the responses for this question is 4.00. Similarly, Question 14, “Revenues should be recognized when a contract exists and the film has been delivered, regardless of whether changes to the film, such as dubbing, must be made” has an estimated median of 3.50. As both medians are greater than 3.00, it can be inferred that there is a preference for the PSOP.

#### *Ultimate Gross Revenue Projections*

In accounting for motion pictures, capitalized production costs are amortized based on the percentage of revenues recognized in that period. Therefore, for each film, management is responsible for developing projections of ultimate gross revenues. Gross revenues can be defined as “the revenue earned by an entity from the distribution, exploitation, or licensing of a film, whether directly or indirectly, before deduction for any costs (for example, taxes, distribution fees, or costs of distribution) but reduced by estimated returns, refunds, or other similar adjustments” (PSOP ¶107). FAS 53 is not

very specific about what can and cannot be included in the projections, but the PSOP specifically excludes revenue from peripheral items, such as toys and clothing. Question 18 on the survey states, “Ultimate gross revenue projections should not include revenue from largely uncertain items such as theme park rides.” For this question, the respondents indicated a statistically significant preference for the PSOP, as the PSOP does not allow revenue from peripheral items to be included in the gross revenue projections. Question 5, “In preparing a cash flow analysis to be used in a budgeting decision, cash flow streams that are largely uncertain should be included,” is related to Question 18 in that both exclude largely uncertain revenues. With an estimated mean of 3.50, Question 5 also indicates a preference for the PSOP.

The PSOP does not allow the inclusion of revenues from any peripheral items: “Ultimate gross revenues should not include revenues from the entity’s manufacture and sale of peripheral items, such as lunch boxes, toys, tee shirts, and so forth” (PSOP ¶29). If you consider a film such as Disney’s *The Lion King* or Lucasfilm’s *Star Wars* which sells numerous peripheral items like dolls, clothing items, lunch boxes, CDs, etc., these items are an integral part of the film’s revenues. Although revenues from them may not be “largely uncertain,” their inclusion is still prohibited under the PSOP. Question 16, “Revenues from promotional items such as toys should be included in the ultimate gross revenue projections” has an estimated median of 2.50, indicating a preference for FAS 53. Therefore, even though the users preferred not to have “largely uncertain” items included in the revenue projections, on the whole, they do not agree with the exclusion of revenue from peripheral items. Based on their responses, we can infer that the

respondents think it is correct to include revenues from any source that are relatively certain, and exclude highly uncertain revenues. This is actually exactly what FAS 53 intended; it is only because the statement did not specifically state what must be excluded on included in gross revenue projections that companies were able to abuse it.

### *Amortization Period*

In motion picture accounting, capitalized production costs are amortized against the percentage of revenues recognized, based on management's gross revenue projections. FAS 53 allows the costs to be amortized over twenty years, while the PSOP will not allow a period longer than ten years. Each of the questions in Group Three refer to amortization periods. Question 7 states, "Intangible assets, such as trademarks and trade names, should be amortized over their economic lives regardless of their legal lives." Question 17 states, "Capitalized production costs should be amortized against the entire revenue stream of the film." In both cases, the respondents indicated a statistically significant preference for amortization over economic lives of assets, instead of a prescribed time period. Likewise, responses to Question 3, "Purchased goodwill should always be amortized over 40 years" with an estimated median of 2.00, indicate a preference for using the economic life of goodwill as the amortization period.

There are two questions that specifically refer to the amortization period for production costs in the motion picture industry. In addition to Question 17, Question 19 states, "Capitalized production costs should be amortized against the revenue stream of a film, but should not exceed ten years." The estimated median for this question was 3.50. It is fairly obvious from the data that respondents are in favor of amortizing assets over

the assets' economic lives. However, in the case of Question 19, they indicated that they preferred this period to be less than ten years. At first glance, these responses may seem contradictory. Yet when one considers that in most cases, "virtually all of a film's revenues are realized within five years," one can see that a respondent could prefer that production costs be amortized over the entire revenue stream of a film and still be limited by the ten-year maximum.

## CHAPTER 5

### CONCLUSION

#### Summary

##### *Introduction*

As stated in APBS No. 4, “The basic purpose of financial accounting and financial statements is to provide financial information about individual business enterprises that is useful in making economic decisions” (§13). Accounting standards determine what information is to be presented and how that presentation is to be done; thus, the highest quality standard is the one that provides the most useful information. In SFAC No.2, the characteristics of quality information are described, with the two primary qualities being relevance and reliability. Relevance consists of timeliness, predictive value, and feedback value, while reliability consists of verifiability, representational faithfulness, and neutrality.

In order to judge the most effective accounting standard, one can look at the relevance and the reliability of the information the standard provides. In this project, there are two accounting standards to examine—FAS 53 and the PSOP. FAS 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, was issued in 1981. Since then, there have been several changes in the entertainment industry,



causing criticism to fall on the standard. For example, in 1981 the primary market for a film was the domestic theatrical market and a producer would realize nearly all of its revenues in the theater. Currently, however, there are several ancillary markets where a producer realizes most of its revenues, including videotape sales, cable television, international sales, and pay-per-view. The business failures of Cannon Films and Orion Pictures have also led to some of the criticism over FAS 53. The PSOP was written in order to address some of this criticism.

### *FAS 53 and the PSOP*

There are many differences between FAS 53 and the PSOP, but the ones I chose to focus on relate to income recognition. The first major difference deals with advertising costs. SOP 93-7 requires that all advertising costs be expensed as incurred, yet FAS 53 allows different treatment for the motion picture industry. Motion picture producers are allowed to capitalize advertising costs that benefit future periods, such as the costs of national advertising, but the PSOP would require that these costs be expensed as incurred. The second difference between the two standards deals with the cost of abandoned projects. Under FAS 53, when a producer abandons a script or project, any resulting loss is simply allocated to the overhead pool. This overhead pool is then amortized over future films in future periods. However, the PSOP would require that these costs hit the income statement in the current period.

The two standards also differ over the timing of revenue recognition from a licensed film. Under FAS 53, as soon as a film is delivered, the producer can recognize the revenue. This follows the belief that delivery of a film is the “critical event” in the

earnings process. The PSOP, however, does not believe that delivery of a film is enough to allow revenue recognition. As changes to a film, such as the addition of subtitles or the editing of content, may be necessary after delivery, the PSOP only allows revenue recognition after these changes are complete.

The final two changes proposed by the PSOP deal with the amortization of production costs. In the motion picture industry, all production costs are capitalized as inventory. These costs are then amortized against the percent of total revenues earned in the period. In order to know what percent of revenues has been earned, the producer must estimate the ultimate amount of gross revenues. This estimate is done using the individual-film-forecast method, meaning that management must develop projections for each film on an individual basis. Both Cannon Films and Orion Pictures over-estimated gross revenue projections, thus were able to amortize less production costs and report higher income. Companies operating under FAS 53 are allowed to include revenue projections from all markets, including the sale of peripheral items. That means that estimated sales from items such as toys and clothing can be included in the projections. The PSOP does not allow revenues from peripheral items to be included, however, under the belief that these amounts are highly uncertain and difficult to estimate. Additionally, FAS 53 requires that the amortization of production costs be completed in a period not to exceed twenty years, while the PSOP does not allow a period beyond ten years.

### *Research Methodology*

In this project, I looked at the primary differences between the two standards in order to determine which standard provides the better method. I believe the best way to

accomplish this was to look at the quality (i.e. relevance and reliability) of the information provided by each statement and examine which information leads to better decisions by the users. As the PSOP is not yet in effect, there is no information in the market from which to perform this analysis, thus one can only make assumptions about the quality of this information. Therefore, in order to test my hypotheses, I decided to send a survey to users of the financial statements and gain their opinions regarding the two standards.

I sent out 150 total surveys to three groups of users—executives in the entertainment industry, public accountants, and accounting professors. The survey was designed in three sections. Each of the first two sections used a Likert-type rating scale, asking the respondents to indicate the extent to which they agreed with a statement. The first section contained a series of statements about accounting in general, and asked about issues dealing with income recognition, but not in the motion picture industry. The second section dealt with income recognition specifically, and the final section was intended to gather demographic information. The surveys were mailed out in the middle of January, and 17 responses were received for an 11.33% response rate.

### *Statistical Results*

Of the nineteen questions that made use of the Likert-type rating scale and were intended to measure the respondent's attitudes on certain topics, four questions produced statistically significant results. The first question was significant with a preference for amortizing intangible assets over their economic lives, regardless of their legal lives. Not surprisingly, there was also a significant preference for amortizing films over their

economic lives. Another question showed a significant preference for using the percentage-of-completion method of recording revenue for construction companies, instead of the completed contract method. Finally, the last question related to the ultimate gross revenue projections. The respondents showed a significant preference for not including revenues from largely uncertain items, such as theme park rides, in the revenue projections.

## **Conclusions**

### **Hypothesis H<sub>1</sub>: Exploitation costs should be expensed as incurred, as provided by the PSOP.**

There are two questions of the survey that asked the respondents' opinions regarding exploitation costs—which consist primarily of advertising costs—in the motion picture industry, and neither question showed a preference for either standard. However, the respondents did show a preference for expensing advertising costs as incurred when asked a general question about current GAAP. Expensing advertising as incurred, as required by the PSOP, forces the motion picture industry to use the same treatment that is used in other industries. While advertising may indeed be crucial to the success of a film, the same argument can be applied to virtually any product, but as the direct effects of the advertisements are largely uncertain and difficult to measure, their costs are not capitalized. The criteria for recognizing an asset require that the item be measurable: “a relevant attribute must be quantifiable or measurable with sufficient reliability” (Hartman, et.al 151). The future benefits of advertising, even if it is national advertising, are difficult to quantify with sufficient reliability.

When the PSOP was originally written, it allowed the costs of national advertising to be capitalized and amortized over a period not to exceed three months. However, after the original comment period, this rule was changed to expensing all advertising costs as incurred. Therefore, one can assume that this change was made because the users responded that they would prefer to have the costs expensed as incurred. SFAC No. 6 further offers reasons why advertising costs should not be capitalized:

Uncertainty about business and economic outcomes often clouds whether...particular items that might be assets have the capacity to provide future economic benefits to the entity...sometimes precluding their recognition as assets. The uncertainty is not about the intent to increase future economic benefits but about whether and, if so, to what extent they succeeded in doing so. Certain expenditures for...advertising...are examples of the kinds of items for which assessments of future economic benefits may be especially uncertain. The practical problem is whether future economic benefit is actually present and, if so, how much—an assessment that is greatly complicated by the feature that the benefits may be realized far in the future, if at all (§175, §176).

Thus, advertising costs in the motion picture industry should be expensed as incurred.

**Hypothesis H<sub>2</sub>: The costs of abandoned projects should be charged to the current period's income statement, as required by the PSOP.**

FAS 53 allows the costs of abandoned projects and scripts to be allocated to the producer's overhead pool, while the PSOP requires these amounts to be charged against income in the current period. Respondents to the survey showed a preference for the PSOP's treatment of these costs. Although the amounts would hit the income statement eventually using either method, immediate expensing provides the user with more relevant information, which can lead to better decisions. Thus, the cost of abandoned projects should hit the current period's income statement.

**Hypothesis H<sub>3</sub>: Revenue from licensed films should not be recognized until modifications to the films are complete, as required by the PSOP.**

The revenue recognition differences between FAS 53 and the PSOP deal with licensed films. FAS 53 allows recognition upon delivery, while the PSOP first requires modifications to the film to be complete. When asked in two separate questions, respondents to the survey indicated a preference for recognizing revenue only after modifications have been made. Although FAS 53 argues that the “critical event” that should allow recognition is the delivery of the film, the respondents apparently do not agree. Instead, they believe that the earnings process is only complete after changes to the film have been made and the right of return no longer exists. Thus, revenue from licensed films should be recognized only when all modifications to the film are complete.

**Hypothesis H<sub>4</sub>: Ultimate gross revenue projections should not include revenues from the sale of peripheral items, as required by the PSOP.**

The development of gross revenue projections is one of the main sources of debate in motion picture accounting, as well as one of the areas most abused—take Cannon Films and Orion Pictures as examples. While FAS 53 does not list what cannot be included in the projections, the PSOP specifically states that revenues from peripheral items should not be included. The survey respondents showed a significant preference for not including revenues from the sale of peripheral items that are largely uncertain, such as amusement park rides. However, the respondents did not indicate a preference for excluding revenues from *all* peripheral items in the projections. While revenues from such items may be difficult to estimate, management has experience in this area and is likely to develop reasonable expectations, just as they are for the film revenues. While

Cannon and Orion did indeed purposely over-estimate ultimate gross revenues, this was due more to unethical management than to a problem regarding what can be included in revenue projections. For example, even if revenues from peripheral items were excluded, management could still over-estimate its future revenues. Thus, if revenues are fairly certain and fairly estimable, they should be included in the projections, regardless of their source.

**Hypothesis H<sub>5</sub>: The maximum period of amortizing production costs should be ten years, as required by the PSOP.**

In three separate questions on the survey, respondents indicated a preference for amortizing assets over their economic lives. FAS 53 and the PSOP allow different maximum periods of amortization—twenty years versus ten years. As virtually all of a film’s revenues are realized within five years after its release, a period of ten or twenty years for a film is not as arbitrary as some accountants believe 40 years is for purchased goodwill (Atlas 64). While AcSEC agrees that “the significant majority of a film’s revenues will have been earned within the ten-year period,” they also acknowledge “that the ten-year provision is arbitrary and that most films have lives that extend beyond ten years” (PSOP ¶93). Yet they believe that the ten-year period would make comparability within the industry greater, as companies currently vary in their practice—both from each other and from film to film. Additionally, respondents indicated a preference for amortizing costs over a period not to exceed ten years. Thus, production costs should be amortized over a film’s economic life, though not to exceed a period of ten years.

**Hypothesis H<sub>6</sub>: The PSOP is a better accounting standard than FAS 53.**

To summarize the conclusions reached on the five above hypotheses, the PSOP is preferred in four out of the five issues regarding income recognition. FAS 53 is only preferred on the issue of including peripheral items in ultimate gross revenue projections. There are additional criticisms of the PSOP that should be looked at before determining which of the two standards provides higher quality information. First, the PSOP does not correct all of the criticisms of FAS 53. When SOP 79-4, *Financial Accounting and Reporting by Producers and Distributors of Motion Picture Films*, was originally issued, some of the comment letters expressed dissatisfaction with the classification of motion pictures as both current and non-current inventory. They felt that films fit the definition of long-term assets and should be treated as such. Even the PSOP states, “One of the underlying conclusions...is that films are more like long-lived assets than inventory” (iii). However, since the original issuance of the PSOP, which considered films to be long-term assets instead of inventory, AcSEC has changed its mind and has not proposed any change in classification.

Another criticism of FAS 53 that is not addressed by the PSOP deals with inconsistency in the treatment of receivables/liabilities between the motion picture industry and the broadcasting industry. Under FAS 53, when a motion picture producer recognizes a receivable from a broadcaster, it immediately records the receivable at discounted value. However, the broadcaster does not have to record the liability at the same amount—it can choose to immediately record it at the discounted amount *or* to record it later at the gross amount. Because industry representatives participate in the



standard setting process, “They have their own interests at heart and naturally establish standards that are biased...Motion picture distributors want to recognize revenue as early as possible while broadcasters would prefer to delay recognizing the liability” (Wolk, Jere, and Tearney 301).

However, although not perfect, the PSOP does significantly improve accounting for motion pictures. It addresses significant changes in the industry, such as the large and rapid growth of ancillary and international markets, which have occurred since the issuance of FAS 53. It also increases the relevance and reliability of accounting information, and by requiring specific amortization periods and guidelines for projecting ultimate gross revenues, more comparability and consistency, and the benefits of implementing the PSOP outweigh the costs. Finally, the attention given to revenue recognition in the PSOP is consistent with current SEC action regarding revenue recognition (consider SAB 101, *Revenue Recognition in Financial Statements*, for example). Therefore, despite the fact that the PSOP fails to correct all of the criticisms of FAS 53 and does not allow peripheral items to be included, even if they are fairly certain and fairly estimable, the PSOP is a higher quality accounting standard than FAS 53 and should be implemented. FAS 53 was an improvement in motion picture accounting when it was issued, and the PSOP would also be an improvement if it is issued.

## **Other Findings**

### *Research*

In addition to the findings that my statistical results provided, I also have some findings that relate to research in general. I chose to study accounting for motion pictures because it is a topic that I find interesting and because I thought it would be an important issue to many public accountants and industry representatives. Before I began my research, I was expecting that there would be much more controversy than the amount that I actually discovered. Despite the fact that it is a highly technical topic specific to one industry, I was expecting to observe much more opinionated responses to my surveys.

In spite of the low response rate, I was able to learn some important information about this topic. It is apparent that many of the entertainment companies must not expect the PSOP to have a large impact on them. There are not many publicly traded entertainment companies, and the ones there are do not rely solely on revenues from motion pictures. Consider a company such as Viacom, where approximately only 35% of its revenues come from entertainment (motion pictures and television combined). They may not feel that the PSOP will have a large impact on their financial statements, and therefore are not very concerned with the changes in the standard. Also, as the PSOP has not yet been approved or implemented, the market has not yet reacted. Therefore, people may be more interested in the topic once the standard is implemented.

### *Response Rate*

Despite the fact that the number of participants responding to the survey seems low (at 11.33%), this is quite a good response rate considering the topic. As mentioned earlier, when the AICPA issued the PSOP, only 28 comment letters were received.

Daniel J. Noll, AICPA Technical Manager, said “Note that there are not that many film entities (and related auditors) out there. I would say that we had a very good response” (email 5/9/00). Thus even the standard setters themselves are not able to draw out many emotional reactions on this topic.

### *What to do Differently Next Time*

Because of the low response rate faced by the AICPA and the fact that I sent out surveys to a good part of the interested population, I would not expect to find a better response rate by sending the survey to more people. Although perhaps a different cover letter or colors for the survey may have slightly increased the response rate, I really do not think so. As I found out, using a survey as the primary research technique in such a technical area is difficult. However, there were two reasons why I was limited in my ability to perform other research techniques. The first is due to the fact that I am an undergraduate student at a school in a city where there are no large motion picture companies. Therefore, The Ohio State University does not have connections with public accountants and industry professionals in the entertainment industry. The second limitation has to do with time. As the survey was mailed out in January and I was on an internship away from school until the end of March, it would have been difficult to

implement another technique after I discovered that there was not as much interest in the topic as I had thought.

There are some things I would change if I were to do this or a similar research project again. The first thing has to do with the actual questions on my survey. As I have said, each question was set up with at least one other question that was intended to check the consistency of the respondent's answers. These questions were then placed into five groups that should have been correlated. However, when I performed the statistical analysis, the Cronbach's alphas for only one out of the five groups of questions showed a strong positive correlation between the questions. Therefore, some of my questions may have been interpreted differently than the way I intended. To repeat the experiment, I would re-word some of the questions—or replace them with entirely new ones—to develop questions that are more closely correlated.

Another change I might make next time would be to send out a second mailing of the survey. This might serve as a reminder to people about filling out the survey and perhaps encourage more of them to respond. Better results could have also been obtained by changing the research methodology entirely. As accounting for motion pictures is such a technical topic with only a small number of people possessing interest and knowledge in the topic, I could have also done small-group or focused interviews (although in practice this would have been difficult to accomplish with my time and location constraints). Through focused interviews I could have obtained more in-depth information. However, by doing case studies or small interviews, I would not have been able to generalize the data.

## **Conclusion**

The primary purpose of accounting is to provide information that can be useful in making decisions, and users of financial statements must rely on the information in financial statements. Although standard setters are not responsible for protecting users from uncertainty or for making decisions for them, they are responsible for how and what information should be presented. It is difficult to set a perfect accounting standard, especially when industries and economies are constantly changing, and therefore accounting standards must continually improve. This is especially fitting in Hollywood, where roles and scenery is constantly changing, and nothing seems to be real anyway. In fact, as long as FAS 53 is the standard setting the rules for accounting for motion pictures, my advice is: Do not “trust Hollywood accounting, because much of it is as make-believe as the movies” (Berton and Harris 46).

## BIBLIOGRAPHY

- Accounting Principles Board. "ABP Statement No. 4: Section 1021." October 1, 1970. Lexis-Nexis.
- Accounting Principles Board. "APB Opinion No. 10: Omnibus Opinion – 1966." December 1966. Lexis-Nexis.
- Accounting Principles Board. "APB Opinion No. 17: Intangible Assets." August 1970. Lexis-Nexis.
- American Institute of Certified Public Accountants. "Arthur Levitt Addresses 'Illusions.'" Journal of Accountancy No. 6 Vol. 186 pp. 12-13 December 1998.
- American Institute of Certified Public Accountants. "Proposed Statement of Position: Accounting by Producers and Distributors of Films." Exposure Draft. New York: October 16, 1998.
- American Institute of Certified Public Accountants. "Statement of Position 93-7: Reporting on Advertising Costs." December 29, 1993. Lexis-Nexis.
- American Institute of Certified Public Accountants. "Statement on Auditing Standards No. 69: The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report." January 1992. Lexis-Nexis.
- American Institute of Certified Public Accountants. An AICPA Industry Accounting Guide: Accounting for Motion Pictures. New York: 1973.
- Arsham, Hosseim. "Statistical Data Analysis: Prove It with Data." <http://ubmail.ubalt.edu/~harsham/stat-data/opre330.htm> (17 May 2000).
- Atlas, Riva. "Reel Numbers" Forbes, Aug 29, 1994, 154(5): 61-64.
- Barr, Stephen. "Show & Tell" CFO Vol. 16 No. 3 March 2000.
- Bengel, Ross; Ikawa, Bruce. "Where's the Profit?" Management Accounting, Jan 1997, 78(7): 40-47.

Berton, Lee and Harris, Roy. "Making The CFO a Player in Hollywood: Reel-World Accounting." CFO Vol. 15 No. 3 March 1999.

"Changes to Film Accounting." Practical Accountant July 1999.

Cheatham, Carole, Dorothy A. Davis, and Leo R. Cheatham. "Hollywood Profits: Gone with the Wind?" The CPA Journal Feb. 1996.

Daniels, Bill, David Leedy, and Steven D. Sills. Movie Money: Understanding Hollywood's (Creative) Accounting Practices. Los Angeles, Silman-James: 1998.

Devore, Jay L. Probability and Statistics for Engineering and the Sciences. 4<sup>th</sup> ed. Cincinnati, Duxbury: 1995.

Financial Accounting Standards Board. "FAS No. 53: Financial Reporting by Producers and Distributors of Motion Picture Films." Stamford, December 1981.

Financial Accounting Standards Board. "Proposed Statement of Financial Accounting Standards: Rescission of FASB Statement No. 53." Exposure Draft. Norwalk, October 16, 1998.

Financial Accounting Standards Board. "Statement of Financial Accounting Concepts No. 1: Objectives of Financial Reporting by Business Enterprises." Stamford, November 1978.

Financial Accounting Standards Board. "Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information." Stamford, May 1980.

Financial Accounting Standards Board. "Statement of Financial Accounting Concepts No. 5: Recognition and Measurement in Financial Statements of Business Enterprises." Stanford, 1984.

Financial Accounting Standards Board. "Statement of Financial Accounting Concepts No. 6: Recognition and Measurement in Financial Statements of Business Enterprises." Stanford, 1984.

Fitzsimons, Adrian P; Shoaf, Victoria L. "Accounting by Producers and Distributors of Films." Commercial Lending Review, Spring 1999, 14(2): 63-71.

Grover, Ronald. "Dances with Debts: Why Orion is Reeling." Business Week No. 3226. 12 August 12 1991, 56.

Hartman, Bart P. et. al. Intermediate Accounting. 2<sup>nd</sup> ed. Cincinnati: South-Western

College, 1998.

Klady, Leonard. "Hollywood Mulls New Measuring Stick." Variety Nov 23-29 1998, 5.

Leedy, David J. Motion Picture Distribution: An Accountant's Perspective. Los Angeles: David Leedy, 1980.

"Lights! Camera! AcSEC! Proposed Changes in Entertainment Industry Accounting Methods." Journal of Accountancy No. 6 Vol. 186 p. 11 December 1998.

Noll, Daniel J. Email: Dnoll@aicpa.org (9 May 2000).

O'Donnell, Pierce and Dennis McDougal. Fatal Subtraction: The Inside Story of Buchwald v. Paramount. West Hollywood: Dove, 1996.

Pouschine, Tatiana. "Now You See It..." Forbes Vol 138 No 5. Sept 8, 1986, 35-36.

Reither, Cheri L. "What are the Best and Worst Accounting Standards?" Accounting Horizons Vol. 12 No 3. September 1998, pp. 283-292.

Schuman, Howard and Presser, Stanley. Questions and Answers in Attitude Surveys: Experiments on Question Form, Wording, and Context. Academic Press, New York: 1981.

Securities and Exchange Commission. "SEC Staff Accounting Bulletin: No. 101 – Revenue Recognition in Financial Statements." December 3, 1999.  
<http://www.sec.gov/rules/acctreps/sab101.htm> (3 May 2000).

Solomons, David. Making Accounting Policy: The Quest for Credibility in Financial Reporting. New York: Oxford UP, 1986.

Thomas, Susan J. Designing Surveys That Work: A Step-by-Step Guide. Corwin Press, 1999, Thousand Oaks.

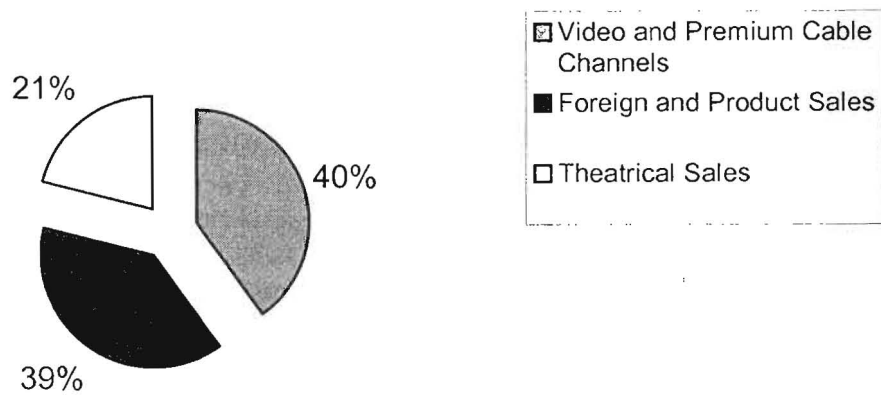
Vogel, Harold L. Entertainment Industry Economics: A Guide for Financial Analysis. New York: Cambridge UP, 1998.

Wolk, Harry I., Jere R. Francis, and Michael G. Tearney. Accounting Theory: A Conceptual and Institutional Approach. Boston: Kent, 1984.



## APPENDIX A

### Motion Picture Revenue Breakdown



Data obtained from David Davis, analyst with Paul Kagan Associates (Atlas 61).

**APPENDIX B**  
Comparison of PSOP and FAS 53

<b>PSOP</b>	<b>FAS 53</b>
<ul style="list-style-type: none"> <li>• Syndication revenues would be recorded ratably over the entire licensing period. Revenues cannot be recognized until modifications to the film are completed.</li> </ul>	<ul style="list-style-type: none"> <li>• Syndication revenues are recorded when episodes are delivered (at the first available pay date.)</li> </ul>
<ul style="list-style-type: none"> <li>• Production costs are amortized against total-revenue estimates from a film. These estimates would be based on collections over 10 years and would exclude certain promotional items.</li> </ul>	<ul style="list-style-type: none"> <li>• Production costs are amortized against total-revenue estimates that are based on a period of up to 20 years. Promotional items such as merchandising, toys and theme park spinoffs are included in these revenue estimates.</li> </ul>
<ul style="list-style-type: none"> <li>• Exploitation costs are to be expensed as incurred.</li> </ul>	<ul style="list-style-type: none"> <li>• Exploitation costs are capitalized and written off against total estimated revenues.</li> </ul>
<ul style="list-style-type: none"> <li>• The cost of abandoned scripts and projects are written off directly to the income statement.</li> </ul>	<ul style="list-style-type: none"> <li>• The cost of abandoned scripts and projects are written off to the overhead pool and amortized among future films over several years.</li> </ul>
<ul style="list-style-type: none"> <li>• Films that lose money directly hit the income statement.</li> </ul>	<ul style="list-style-type: none"> <li>• Films that lose money are capitalized in the balance sheet as part of the overhead pool and are amortized over the income of other movies.</li> </ul>

## APPENDIX C

**Please respond to the following statements by circling the number that best indicates the extent you agree or disagree with each statement, using the following scale:**

- | 1  | 2                 | 3                          | 4              | 5     |
|--|-------------------|----------------------------|----------------|-------|
| Disagree   | Somewhat disagree | Neither agree nor disagree | Somewhat agree | Agree |
| 1. Oil and gas production companies should use the full cost method instead of the successful efforts method, and capitalize all costs of exploration and development, whether successful or not.  |                   |                            |                |       |
| 1  | 2                 | 3                          | 4              | 5     |
| 2. Intangible costs associated with opening a new business should be capitalized and amortized over time.  |                   |                            |                |       |
| 1  | 2                 | 3                          | 4              | 5     |
| 3. Purchased goodwill should always be amortized over 40 years.  |                   |                            |                |       |
| 1  | 2                 | 3                          | 4              | 5     |
| 4. Because certain precious metals have a fixed selling price, revenue should be recorded at the end of the production process, even though additional selling and delivery work may be necessary. |                   |                            |                |       |
| 1  | 2                 | 3                          | 4              | 5     |
| 5. In preparing a cash flow analysis to be used in a capital budgeting decision, cash flow streams that are largely uncertain should be included.  |                   |                            |                |       |
| 1  | 2                 | 3                          | 4              | 5     |
| 6. Current GAAP, which requires advertising costs to be expensed as incurred, is sound accounting.   |                   |                            |                |       |
| 1  | 2                 | 3                          | 4              | 5     |
| 7. Intangible assets, such as trademarks and trade names, should be amortized over their economic lives regardless of their legal lives.   |                   |                            |                |       |
| 1  | 2                 | 3                          | 4              | 5     |
| 8. Revenue should be recognized when the seller is no longer exposed to the risk of return of the property.  |                   |                            |                |       |
| 1  | 2                 | 3                          | 4              | 5     |
| 9. Construction companies should recognize revenue using the completed contract method rather than the percentage-of-completion method.  |                   |                            |                |       |
| 1  | 2                 | 3                          | 4              | 5     |

**Questions 10-17 specifically relate to accounting for motion pictures:**

- |   |   |   |   |   |
|---|---|---|---|---|
| 10. Promotional costs, such as the cost to run advertisements on television, should be expensed as incurred.  |   |   |   |   |
| 1   | 2 | 3 | 4 | 5 |
| 11. Revenue should be recognized only when the film is delivered AND all modifications such as the addition of content are complete.                                |   |   |   |   |
| 1   | 2 | 3 | 4 | 5 |
| 12. Any loss resulting from a project that is dropped should be allocated to the producer's overhead pool.  |   |   |   |   |
| 1   | 2 | 3 | 4 | 5 |
| 13. Given advertising is a crucial component of a successful film, these costs should be capitalized.   |   |   |   |   |
| 1   | 2 | 3 | 4 | 5 |
| 14. Revenues should be recognized when a contract exists and the film has been delivered, regardless of whether changes to the film, such as dubbing, must be made. |   |   |   |   |
| 1   | 2 | 3 | 4 | 5 |
| 15. When a producer abandons a script, the resulting loss should be recognized in this period's income statement.   |   |   |   |   |
| 1   | 2 | 3 | 4 | 5 |

**Please use this information to assist you in answering questions 16-19:**

Under the individual-film-forecast method, capitalized production costs are amortized against projected ultimate gross revenues. Therefore, if a film's projected ultimate gross revenues are \$10, capitalized production costs are \$5, and the film's first-year actual revenues are \$5, then production costs of \$2.50 are amortized. Note that if ultimate projected gross revenues had been \$20, only \$1.25 would have been amortized.

16. Revenues from promotional items such as toys should be included in the ultimate gross revenue projections for a film.

1	2	3	4	5
---	---	---	---	---

17. Capitalized production costs should be amortized against the entire revenue stream of the film.

1	2	3	4	5
---	---	---	---	---

18. Ultimate gross revenue projections should not include revenue from largely uncertain items such as theme park rides.

1	2	3	4	5
---	---	---	---	---

19. Capitalized production costs should be amortized against the revenue stream of a film, but should not exceed ten years.

1	2	3	4	5
---	---	---	---	---

20. Are you familiar with the accounting procedures set forth in SFAS No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*?

YES (please continue to Question 21) NO (please skip to Question 25)

21. Are you familiar with the proposed SOP, *Accounting by Producers and Distributors of Films*?

YES (please continue to Question 22) NO (please skip to Question 25)

22. Which standard do you think would result in better accounting information?

SFAS 53	NO OPINION	PROPOSED SOP
---------	------------	--------------

23. The major problem areas with SFAS 53:

- a. Allows for significant variations in application and lack of comparability
- b. Lack of a set method to estimate ultimate gross revenues
- c. Does not address extensive changes in industry that have occurred since its issuance
- d. Results in inaccurate financial statements (as proven by certain business failures)
- e. Allows for smoothing of income
- f. Other:

24. The major problem areas with the proposed SOP:

- Requires too much bookkeeping and is too complicated
- Does not significantly improve accounting for motion pictures
- Takes away flexibility and creativity from accountants
- Fails to record films as long-term assets (as opposed to current and noncurrent inventory)
- Fails to discount ultimate gross revenue estimates to present value
- Other:

25. Years experience (check all that apply):	<b>0-5</b>	<b>6-10</b>	<b>11-15</b>	<b>16+</b>
Teaching	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Auditing/Tax/Consulting	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Industry	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

26. Number of years dealing with issues relating to the entertainment industry:

27. Sex: MALE FEMALE

28. Please circle the place where you would prefer to take a vacation: LAS VEGAS NEW YORK

# APPENDIX D Histograms: Questions Realigned so that High Score Suggests Preference for PSOP

